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PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

MARCH 9, 10, 16, 17, 23, 31; AND APRIL 1, 1993

PART 1 OF 2

MARCH 9, 10, 16, AND 17, 1993

Serial 103–26

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SUBMISSIONS FOR THE RECORD

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

TUESDAY, MARCH 9, 1993

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
FRIDAY, FEBRUARY 26, 1993

PRESS RELEASE #4
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold hearings on President Clinton's proposals for public investment and deficit reduction. The hearings will be held on March 9, 10, 16, 17, and 23, 1993, in the main Committee hearing room, 1100 Longworth House Office Building. Testimony will be heard from invited witnesses, Members of Congress who request to testify, and the public.

The following invited witnesses will appear on the dates and times noted:

Tuesday, March 9, 1993:

10:00 a.m.	The Honorable Leon Panetta, Director Office of Management and Budget
2:00 p.m.	The Honorable Laura D'Andrea Tyson, Chair Council of Economic Advisors

Wednesday, March 10, 1993:

10:00 a.m.	The Honorable Lloyd Bentsen Secretary of the Treasury
2:00 p.m.	The Honorable Donna Shalala Secretary of Health and Human Services

Tuesday, March 16, 1993:

10:00 a.m.	Robert Reischauer, Director Congressional Budget Office
2:00 p.m.	Public witnesses

Wednesday, March 17, 1993:

10:00 a.m.	Public witnesses

Tuesday, March 23, 1993:

10:00 a.m.	Public witnesses

In announcing these hearings, Chairman Rostenkowski stated: "President Clinton has proposed a bold package that combines targeted public investment with serious deficit reduction. It is a comprehensive proposal, affecting nearly every sector of our economy and most individual Americans. These hearings are a very important step in the legislative process -- an opportunity for the President's advisors to explain the plan in detail to the Committee and for Members of Congress and the interested public to express their views."

SCOPE OF THE HEARINGS:

In his February 17, 1993, address to Congress, President Clinton proposed a three-part package of legislative initiatives to the Congress: economic stimulus, public investment, and

(MORE)

deficit reduction. At these hearings, the Committee invites testimony on the Administration's public investment and deficit reduction proposals which fall within the jurisdiction of the Committee on Ways and Means. Public witnesses are asked to limit their testimony to the revenue matters proposed by the President. In the near future, hearings will be scheduled by the appropriate Subcommittees of the Committee on Ways and Means to hear testimony on the health, social security, and human resource matters included in the President's proposal.

With respect to investment, the President has proposed creating enterprise zones, expanding the earned income tax credit, creating a permanent investment tax credit for small business and a temporary incremental investment tax credit, reducing taxes on capital gains for certain invesments in small business, and extending a number of the tax provisions that expired last year.

The deficit reduction package includes both spending reductions and revenue increases. Within the Committee's jurisdiction, the largest spending reductions proposed are in the Medicare program, which the Administration would reduce by $49.5 billion through fiscal year 1998. The President's proposals include reductions in administrative funds for the Supplemental Security Income and Aid to Families with Dependent Children programs, improvements to make more effective the child support enforcement program, and changes in the tax treatment of Social Security benefits. Finally, the President's deficit reduction strategy suggests increases in corporate and individual taxes, the creation of a broad-based energy tax, and a number of smaller provisions. The package also includes a number of "user fees," some of which may fall within the jurisdiction of the Committee on Ways and Means.

<u>DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD</u>:

Members of Congress, individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland or Karen Ponzurick [(202) 225-1721] no later than Monday, March 8, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 300 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

(MORE)

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on Tuesday, April 6, 1993, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 200 additional copies for this purpose to the Committee office before the hearings begin.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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FOR IMMEDIATE RELEASE
FRIDAY, MARCH 12, 1993

PRESS RELEASE #5
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES ADDITIONAL HEARINGS ON PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold two additional days of hearings to accommodate public requests to testify on President Clinton's proposals for public investment and deficit reduction. The hearings will be held on Wednesday, March 31, and Thursday, April 1, 1993, beginning at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.

These hearings are in addition to the hearings announced for March 9, 10, 16, 17, and 23, 1993. Testimony will be received only from those public witnesses who have already requested to testify in response to the February 26, 1993, press release. (The hearings were announced and the scope of the hearings was described in press release #4, dated February 26, 1993.)

*****

Chairman ROSTENKOWSKI. The committee will come to order.

This morning the Committee on Ways and Means begins a series of hearings on President Clinton's proposals for public investment and deficit reduction. We begin these hearings with testimony from key members of the Clinton administration who will describe the President's proposal. Following the administration witnesses, we will receive testimony from Members of Congress and the public who will comment on the President's plan.

As we start these hearings, I want to commend President Clinton for presenting us with a bold and courageous legislative package. His proposal is comprehensive and balanced. It affects nearly every sector of our economy and most individual Americans.

The President has chosen a three-pronged approach to the problem that this Nation faces, an economic stimulus package to ensure that our economic recovery continues and extends to all of our citizens, a public investment package to move this country well along the road of long-term economic growth and improved quality of life, and the deficit reduction package which combines specific spending cuts and tax increases to begin to eliminate the massive debt burden of the Federal Government.

This committee has a tremendous responsibility with respect to the administration's proposals. We have jurisdiction over at least a quarter of the spending cuts proposed by the President and more than half of the entitlement cuts. Most of these reductions are in the Medicare program, which the administration proposes to reduce by more than $48 billion in fiscal year 1998. In addition, the President is proposing new State fees for the supplemental security income program, reductions in administrative funds for the aid to families with dependent children program, and increases in the amount of Social Security benefits subject to tax.

On the revenue side, the President has proposed a number of tax incentives as part of his economic stimulus and long-term investment program, including a permanent investment tax credit for small businesses, a temporary incremental investment tax credit for other businesses, enterprise zones, capital gains for certain investments in small business, and an expansion of the earned income tax credit.

Revenues also are part of the President's strategy to reduce the deficit. He has proposed increases in corporate and certain high-income individual's taxes, the creation of a broad-based energy tax as well as a number of smaller revenue-raising provisions.

These hearings are a very important part of the legislative process for this committee. We want to be sure that we understand the President's program before we act upon such significant changes, and we want to hear the views of the American people. I look forward to the testimony of all our witnesses.

Now I would like to welcome to the committee for the first time our former colleague, the Honorable Leon Panetta, in his capacity as Director of the Office of Management and Budget. Leon, congratulations. I know that you accept this responsibility with great fervor. We have worked together in your capacity here in the House of Representatives as chairman of the Budget Committee. I think, in most instances, the views that you have expressed as chairman of the Budget Committee, presently as Director of OMB,

are pretty parallel to a great many of the membership here on this committee.

I know that your task is awesome, and I hope that you recognize, after testifying on the Hill now for the last several weeks, that we are pretty much aware of what we are going to hear. But I want you to understand something, Mr. Director. It all begins here, and so I hope that we will have the cooperation of your office, and certainly I feel that I express the feeling of all of the members of this committee that we are going to work in concert with you in trying to get the economy of this country back on track.

Any further comments?

[By unanimous consent, the opening statement of Mr. Archer was inserted at this point:]

Opening Statement of the
Honorable Bill Archer
Full Committee Hearing
OMB Director Panetta
March 9, 1993

Mr. Chairman:

Let me begin by welcoming our former colleague and Budget Chairman Mr. Panetta to the Committee this morning.

Your appearance is very important and very timely. At the moment we don't have a detailed Presidential budget, but I'm sure you can enlighten us about many of the individual proposals that have been mentioned.

Congress is also moving very quickly to ratify your economic package with a budget resolution by the beginning of April. Yet it isn't as if the budget resolution will be different from the package the President discussed in his speech before Congress. I trust you will update us on this.

It's obvious, however, that the budget resolution will contain large reconciliation requirements. Then the role of the Ways and Means Committee will become tremendously important to the success of the package. Simply put, without the tax increases, you have no deficit reduction.

It is my opinion along with several others, that the backbone of your deficit reduction plan is a large tax increase. The respected American Enterprise Institute puts the ratio of tax increases to spending cuts at four to one. That's if you assume as I personally do not, that the out-year spending cuts will actually materialize. Using Congressional Budget Office numbers, the House and Senate Budget Committees calculate the same result as A.E.I

Before we head off pell mell in this new direction, I think the Committee should ask itself a serious question. Did raising $165 billion in new taxes in the 1990 deficit reduction package solve our deficit problems? Of course not. Instead of the deficit hitting $56 billion in FY 94 as was predicted in 1990, the CBO now projects it at $287 billion. Who then believes that again raising taxes $360 billion, accompanied by at least $186 billion dollars in new spending, will solve the deficit?

Even your Administration has already admitted that the deficit will keep increasing due to health care costs. But while I agree with you that health costs are a problem, they are not solely the problem. This government spends too much on programs that are outdated, that do not deliver results and that skim too much of the program dollars off the top in administering them. Until we address these factors, the cost drivers in the federal government will remain in place.

A good case in point is your so-called economic stimulus. I'm afraid it's just such an example of money expended unwisely. With economic growth its highest in many years, worker productivity at a 20 year high, and unemployment down, how can this be justified as emergency spending? According to CBO it will violate our legal spending limits in the next two fiscal years.

Analysis from several economic forecasters conclude that the total Clinton package could result in job losses in 1997 and 1998, even if the Federal Reserve loosens credit. Higher taxes on entrepreneurs -- the people who create jobs -- and your tax incentives tilted toward investing in machinery and not labor will result in no stimulus this year and lower growth thereafter. I think we court real danger by trying the American people's patience with policies that just don't deliver. I think we should drop a stimulus plan that produces no jobs and concentrate on cutting the deficit in ways that do not discourage new job creation.

Before I close, I would like to make one further comment. The President stated in his speech before the nation that he would use the CBO numbers, not the assumptions, but the numbers for accounting purposes. I hope you are taking very seriously CBO's and Joint Tax Committee's analysis of your plan.

I realize that in an attempt to increase your spending cuts you classified the tax on social security benefits as an outlay reduction. But both CBO and Joint Tax classify this as a tax increase, and so will this Committee. We know if we enact the provision the taxpayers will treat it as one when they map the financial strategies.

And there are other serious issues raised by the congressional estimators' preliminary analyses. For example, CBO says your baseline for discretionary spending has been increased $41 billion over their own numbers that are based on the spending path agreed to in 1990.

Perhaps more troubling is the shortfall in your total deficit reduction. Joint Tax currently estimates your revenue package will fall short by nearly $28 billion. When combined with the shortfall in spending, you are more than $60 billion off your deficit reduction goal.

Mr. Chairman, the American people expect a plan that lowers the deficit and keeps the budget in control through spending restraint. I urge the President to make this his utmost priority in the next few months.

I wish you the best of luck in your new role, Mr. Panetta, and look forward to working with you in the coming months.

Chairman ROSTENKOWSKI. Mr. Panetta, you may begin.

STATEMENT OF HON. LEON E. PANETTA, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. PANETTA. Thank you very much, Mr. Chairman and members of the Ways and Means Committee. It is an honor to again have the opportunity to come back to the House, which is my home, and to have the opportunity to appear before this distinguished committee and Members from both sides of the aisle who are represented on this committee.

In particular, I want to pay my tribute to the chairman since, as chairman of the Budget Committee, we worked a great deal together on various budget summits of one kind or another, budget reconciliation of one kind or another. But in all of my experience this is the committee that has had the toughest responsibility every time we have had to deal with reconciliation because it clearly has had to deal not only with what are very sensitive reductions in programs that are of concern to the American people but also with regard to the tax side of the ledger as well.

So you carry the toughest ball in this committee, and the chairman and the members of this committee have always done an outstanding job of meeting the goals that have been established in every reconciliation measure and in every budget summit. That has not always been easy to do, but I am one who particularly respects the work that has been done in this committee, and I look forward to working with the chairman and the members of this committee as we try to meet the challenge that the President has presented to the Congress and to the country in this economic plan.

Mr. Chairman, I would like to keep my comments as brief as possible to allow maximum opportunity for questions. I think Members are familiar with a lot of the elements that are included in the economic plan as presented in the February 17 document, "A Vision of Change for America," and so I am not going to spend a great deal of time other than to summarize at least the general points I would like to make with you and then be happy to respond to your questions.

Chairman ROSTENKOWSKI. Without objection, then, Mr. Director, we will include your entire statement, and you may summarize.

Mr. PANETTA. I appreciate that. Thank you.

Mr. Chairman, as I have indicated, the process we went through in developing this budget was unprecedented. I have been through a number of—and I think probably in the time that I have been in the Congress over the last 16 years have been a part, as the Chairman has, of every major budget summit, of every major budget debate, and of every major budget reconciliation effort, and I know the process that is involved.

Normally, in the administration, to develop a budget, it takes about 6 months to work with all of the various agencies and departments to get their views, to go through what is called the passback operation of presenting numbers back to the departments, getting their reactions back to the Office of Management and Budget, and so it is a very long process.

As a matter of fact, when we did the budget agreement in 1990, as many of you know, we spent almost 5 months in that discussion

trying to develop the budget agreement that was eventually passed by the House and the Senate, signed by the President. So it normally takes a very long time. But what we did in this instance, because the President wanted to move quickly and present his budget to the country and to the Congress, we basically worked within a 3- to 4-week timeframe.

We began with preliminary discussions back in Little Rock, presenting some general approaches to the overall economic problems and the budget responses to those problems, but we really began to work in depth over the last 3 to 4 weeks and went through a process with the President because this is exactly what he wanted to do, he wanted to familiarize himself with each of the issues that he had to make decisions on as part of the budget, familiarize himself with each major area of the budget.

And so, as a consequence, we went through exactly the same process we went through in budget summits which is to walk through each major area of the budget and present every option. There was no choice that was left off the table. We presented all of the choices to the President in each area so he could evaluate these decisions and make the choices in line with what he thought was in the best interests of this Nation. That is exactly what he did.

It was an unusual process—an unprecedented process. I think the country ought to draw great satisfaction from the fact that the President was willing to walk through that process, make these decisions, make these choices and become familiar with the kind of tough decisions that have to be made if you are serious about dealing with the economic problems facing this country.

I think the United States of America and the people of this country ought to draw some satisfaction from the fact that the President went through that process, so that what you see before you is really the President's mark in terms of an economic plan. These are the principles he believes in. These are the principles that he thinks are important for the country.

In sum, I think the plan tries to provide a very important balance here. As chairman of the Budget Committee, I always said that there are several key elements that every budget ought to have and over the last 12 years we always found some problems with the balance.

Administrations presented their versions of budgets and we responded, but there are always some basic principles you ought to look for in every budget. It ought to be comprehensive. It ought to be fair. It has to be balanced. It certainly should be honest. And, lastly, it needs to be tough but doable. You have got to be able to pass it through both the House and the Senate.

Those are really the fundamental principles that we need to implement, the President tried to implement in the economic plan before you. It is comprehensive. It tries to deal with the problems that we see in the economy. And the problems are not just in the long term but in the short term as well.

I will just briefly discuss each of those areas quickly, but it was basically looking at the short-term problems in the economy, looking at the investment deficit that all of us are familiar with, and

looking certainly at the budget deficit and the need to address all of those.

It is fair. It is fair because what we tried to do is to make certain that we deal with both the public and the private sector in this kind of economic plan. It isn't just a question of looking at the private sector. It is also a question of looking at the public sector and the investments that need to be made on both sides.

The American people in the November election made very clear that this is not an economy that can just be dealt with on one side. We have a fundamental responsibility, at both the public and the private level to confront the problems that face this Nation.

Secondly, it was important, in order to make it fair, that everyone make a contribution. Everyone needs to be part of this process. There should not be any exceptions, and there aren't in this budget. Everybody has to make part of the contribution here, and that is the way it should be.

Thirdly, it is balanced, balanced in terms of dealing with investment as well as deficit reduction. You can't deal with as sensitive a problem as we have in our economy and not look at both the need for investments and targeting those investments as well as deficit reduction. I am not talking about the need for additional spending so much as I am talking about the need for smart spending, targeting that spending in areas that in fact are good investments for us.

When you provide, for example, a dollar in the WIC program, you know you save more dollars in terms of health care costs. When you can immunize kids, you know you are going to save money in terms of long-term health care costs for those kids in the future. That is a reality. That is good investment. It is good investment by anybody's terms.

So it is a balanced package, in looking at both investment as well as the need to reduce the deficit.

Secondly, in terms of both spending as well as revenue, anytime you put together a budget, it obviously has to be balanced on both fronts, but it also has to include both spending reductions and revenues if you are serious about taking on the kind of challenge we face on deficit reduction.

In addition to that, it is honest. One of the things the President made clear, and I made clear to the President before I took this job, is we are going to present a budget to the country that doesn't have black boxes, that doesn't include timing shifts from one fiscal year to another, September 30 to October 1, the way we have seen in the past. That doesn't include accrual accounting gimmicks where you reach into the future and pull back savings that you assume will occur in the future and pull them back and spend them now. And that doesn't include rosy scenarios about where the economy is going.

Let me just tell you, on CBO estimates of this budget over the last 14 years, when you look at CBO estimates, one budget, the Bush budget in 1993, it was almost $111 billion off of where they said the deficit was going to be, $111 billion off largely because of rosy scenarios about where the economy was going. We didn't want to do that, and so what we have here is a very conservative estimate about where the economy is going.

It is basically the CBO projections, using some of the revenue estimates that we have at Treasury because that is the need—in developing our numbers, we have to use Treasury's estimates. But, ultimately, this is a very conservative estimate about where the economy is going, and that is the way it should be. So that if we make progress, if we reduce the deficit, if we make the kind of investments we have to make, that, ultimately, the economy is going to get better as a result of that, and that is what the American public needs to feel as we move forward.

Lastly, it is tough, there are some tough decisions included in this budget, tough on defense spending, tough on the issue of an energy tax, a broad-based energy tax. That is a tough decision, and yet it is something everybody has discussed in terms of a broad consumption tax. Tough in terms of what we have done on Social Security, tough in terms of what we have done on Medicare savings and health care savings, and tough in terms of what we have done to Government.

The Government reduction in this proposal is almost $40 billion, between $35 and $40 billion in cuts on administrative costs, streamlining, reductions in force, a pay freeze. Because the President felt that it was very important, when it comes to dealing with the kind of choices we have to make, to say that the Government is going to step forward to that challenge. And we have a lot to do in terms of our ability to try to make Government respond better to our challenges but also to show that we are willing to make some sacrifices to improve our efficiency as well.

So the plan, as I said, is comprehensive. It is fair. It is balanced. It is honest. And I think it is tough. But, also as important, it is doable. It doesn't do anybody a hell of a lot of good if we make all the tough choices in the world and we can't pass it.

I have been a part of some of those efforts. I think I was part of a number of votes where it was somewhere between 40 to 50 votes on various measures, and that is a nice statement to make, but it doesn't do us a lot of good in terms of putting an economic plan in place. And so whatever is ultimately done, it has to be doable. You have got to make sure that you hold the coalition of votes together in both the House and the Senate side to make it happen. And we think the plan we have presented is doable and that we can hold that kind of coalition together.

I recognize the various criticisms and the kind of comments that we are going to get. That is part of the process. I accept it.

But you know what the test of this plan is? It is what is happening out there beyond Washington. The American people are saying we want something done. This economic plan offers us some hope. We have got to put it in place. No, we don't like every piece of it. No, we don't particularly like this tax, and we don't particularly like this cut, but, overall, this is the right thing to do.

And that tells you a lot. The American people, frankly, are way ahead of us on this one, and they are basically saying it is time to put a plan into place and to get away from the gridlock, get away from the partisanship, get away from the sniping. Let's get it done.

The second test of credibility is what is happening with regard to the bond markets. The fact that when the bond markets look at

the credibility of this proposal, particularly with regard to deficit reduction, what we have seen over the last few weeks is a reduction in basis points in terms of interest rates in this country that approaches almost 85 to 90 basis points. It is almost a full percentage point reduction in terms of long-term interest, and that in and of itself has produced almost somewhere between $80 to $90 billion that has flowed back into the American economy, refinancing, mortgage reductions, the kind of things that really do stimulate the private sector.

That, I think, is also a fundamental test of the credibility of this package. Yes, there are other factors involved. But make no mistake about it. When they looked at this package and said this President is serious about deficit reduction, it made a tremendous difference in the bond markets.

So those are the points I wanted to make with you, Mr. Chairman and members of the committee. Let me say this, this is the beginning of the process. It is not the end. We know there is a lot of work that needs to be done. We know that there are improvements that can be made.

I commend, as the President has, the work of the Budget Committees on both the House and the Senate side. They are working toward trying to, in fact, meet the CBO numbers right on the button. They are doing a little more. Obviously, that has to work its way through the process on both the House and the Senate side, but we commend them for the work they are doing. We are prepared to work with you in trying to make sure that this happens.

We are at an historic moment, and the historic moment is the American people are saying to us, get it done, get this economic plan in place, and that is a challenge that we have to face on both sides of the aisle. We cannot afford to let this historic moment pass and not take action, so I want to urge you, Mr. Chairman and members of this committee, please work with us in this effort, and we will cooperate with you as we try to meet the challenge the President presented to the country.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Leon.

[The prepared statement follows:]

TESTIMONY OF LEON E. PANETTA
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MARCH 9, 1993

Mr. Chairman, members of the Committee, thank you for inviting me to be here today. It's always good to visit the Ways and Means Committee. I have worked well with you for many years, Mr. Chairman, and I am confident that we will be able to cooperate in helping President Clinton change this country for the better.

As you know, the program we have sent to the Congress, outlined in A Vision of Change for America, is not a complete budget. We are aiming to publish a full budget on April 5, with the account by account information on discretionary spending going to the Appropriations Committees on March 25. The Clinton Administration is the first new Administration ever to be required by law to submit a complete budget. I am sure you can understand the difficulty of accomplishing that within only a few weeks. Nevertheless, because of the extraordinary process that the President and members of his economic team went through over a four-week period, we have provided a substantial amount of specific information in this document, enough for the Congress to begin its work on a budget resolution for fiscal year 1994.

We hope that the Congress will move a budget resolution and follow up with a reconciliation bill that implements the key elements of the President's long-term proposals. In addition, we are hoping that the Appropriations Committees will move swiftly on the economic stimulus that is a part of the economic program.

Mr. Chairman, we entitled this document A Vision of Change for America. That title reflects my beliefs about what the American people want from us here in Washington. Americans did not vote last November for the status quo. They voted for change. They were concerned about the current state of the economy, and they were concerned about our country's future, about the legacy we will provide for our children. Those concerns are alive and well, and with good reason.

THE LEGACY WE INHERIT

First, the recovery from the recession has been relatively weak. While we have seen some positive signs, the reality is that the recovery, with the exception of last month's report, has been accompanied by little growth in jobs. The unemployment rate is still higher than it was at what economists refer to as the trough of the recession. Twice before we have seen the recovery process begin, only to sputter when early signs of growth were not followed by solid gains in employment. This time, we must be absolutely sure that the recovery is strong and durable enough to put Americans back to work.

But America's problems are deeper than a temporary lull in economic activity. The American people worry about the future, because they know that our economy and our society are unprepared for the challenges that face us and our children in the 21st century. They worry what kind of economic opportunity our children will have. They wonder whether the next generation will be the first to have lower standards of living than the one that preceded it.

The fact is, to raise standards of living, we must aim for better jobs at higher wages. We must add to our economy's capacity to create a better life for all. To do that, we must improve the productive capacity of our workers. And to do that, we need to close the investment deficit in our economy, the lack of adequate public and private investment in our people, our infrastructure, our plant and equipment, in research and development, and in new technologies that can add to productivity.

The reality is that the United States devotes a smaller fraction of gross domestic product to business investments than do the other major nations with whom we compete in the international marketplace. Likewise, American governments at all levels have been spending a decreasing share of our total resources on civilian public investment -- both physical investment and the research and development that underpins future growth. We have underinvested in education and training as well.

More investment is vital to raising the growth rate of productivity and boosting living standards. We must invest more in business capital, in public infrastructure, and in the skills of our people. Our future has been shortchanged for too long. We owe it to our children to change course now.

Finally, there is the budget deficit. The budget deficit is a major culprit in the investment deficit, because Federal borrowing drains the private resources needed to invest in our economy. Likewise, growing annual interest payments on the debt crowd out other priorities. You all know the numbers. If we do nothing to reduce deficits, they will climb well over $600 billion over the next ten years, robbing the resources we need to make a better life for our children.

President Clinton's economic program seeks to respond to each of these problems.

STIMULUS

First, the President is proposing a $30 billion stimulus package to strengthen and prolong the economic recovery. The focus of the stimulus package is on creating jobs by placing a down payment in the current fiscal year on the long-term investments that will create greater economic growth in the future.

We are asking that Congress pass the stimulus on an expedited schedule. We believe this plan will produce over 500,000 full and part-year jobs through investments in highways, summer youth employment, community development, natural resource protection, summer Head Start, the WIC program, youth employment, veterans facility upgrading and energy conservation.

Some of the major components of the stimulus proposal are: $3.0 billion in highway investments; $2.5 billion in Community Development Block Grants; $845 million in wastewater clean-up initiatives; $1.0 billion in summer youth employment and training; and a temporary incremental investment tax credit.

The spending portion of the stimulus package will be within the overall discretionary spending totals for fiscal year 1993 agreed to in the 1990 Budget Agreement. It is a fiscally responsible measure that can help ensure a strong recovery.

With regard to the tax provisions, we hope these will be enacted, with appropriate effective dates, as part of the reconciliation legislation.

LONG-TERM INVESTMENTS

The second component of the President's program is a four-year plan of carefully targeted public investments in economic growth and jobs. The plan provides $160 billion over four years of investments that focus on rebuilding America through investments in infrastructure, energy and the environment, and housing; improving education and encouraging job training to enhance the current and future productivity of our people; rewarding work by taking working families out of poverty; improving health care and research; and providing incentives to the nation's businesses to invest in technology and improved productivity of people, plants and equipment.

Following are highlights of the additional investments proposed through fiscal year 1997:

REBUILD AMERICA - The Administration plan includes $18.6 billion by fiscal year 97, $48 billion over four years, for initiatives to restore the nation's infrastructure, environment, housing stock, and technology base.

- Transportation - The Administration proposes $3.0 billion in fiscal year 1997, $8.4 billion over four years, for initiatives that include full funding of the Intermodal Surface Transportation Efficiency Act and investments in mass transit, high speed rail, and airport improvements.

- Technology - The Administration proposes $6.1 billion in fiscal year 1997, $17.0 billion over four years for a number of investments including the National Science Foundation, science, engineering and technology grants, high performance computing, and extension of the research and development tax credit.

- Environment - The Administration proposes $3.5 billion in fiscal year 1997, $8.0 billion over four years, including $4.5 billion for clean water and increases for environmental technology, weatherization grants, forestry research, and natural resource protection.

- Energy - The proposal provides over $1.3 billion in fiscal year 1997, $3.0 billion over four years, for such items as energy conservation and renewable energy programs, fusion research and more energy efficient Federal buildings.

- Housing and Community Development - The Administration proposes $3.1 billion in fiscal year 1997, $9.6 billion over four years in Community Development Block Grants, enterprise zones, assisted housing, and extension of the low-income housing tax credit.

- Rural Development - Investments include $620 million in fiscal year 1997, $1.5 billion over four years, in priorities such as rural water and waste loans and grants and community and business development for rural areas.

LIFELONG LEARNING - The Administration $15.7 billion in fiscal year 1997, $37.8 billion over four years for programs to educate and train our people from early childhood through adulthood. Included are defense conversion measures. The following increases are for fiscal year 1997:

- National Service - $3.0 billion
- WIC: full funding by fiscal year 1996 - $984 million
- Head Start: full funding by fiscal year 1999 - $3.7 billion
- Education reform and initiatives - $3.2 billion
- Worker training - $4.1 billion
- Youth Apprenticeship - $500 million
- Parenting and Family Support - $495 million

REWARDING WORK - The Administration proposes $7.5 billion in fiscal year 1997, $25 billion over four years, to remove disincentives for work, protect those who are temporarily unemployed and secure safer communities. These include an expanded Earned Income Tax Credit, the extension of emergency unemployment compensation benefits, and a crime initiative.

HEALTH CARE - The plan provides $9.4 billion in fiscal year 1997, $26 billion over four years, for improving public health programs to help families and make our workers more productive, including the following fiscal year 1997 investments:

- AIDS, women's health, and other public health initiatives - $3.4 billion
- AIDS - Ryan White Act full funding - $394 million
- Drug and substance abuse prevention and treatment - $800 million
- Nutrition assistance and USDA food safety initiative - $102 million

- Improving Social Security disability insurance processing - $200 million
- VA Medical Care - $1 billion

PRIVATE SECTOR INCENTIVES. The plan provides $3.0 billion in fiscal year 1997, $24 billion over four years, for carefully targeted incentives and initiatives to encourage investments that provide technological gains and improved productivity of plants, equipment, and people, including:

- a targeted capital gains provision
- alternative minimum tax relief for corporations
- a permanent small business investment tax credit
- real estate investment incentives

DEFICIT REDUCTION

Finally, the President is proposing the largest deficit reduction package in history. The gross deficit reduction measures in this package -- the total spending cuts and tax increases before investments are subtracted -- are almost $500 billion over four years and over $700 billion over five years. The plan achieves $140 billion of net deficit reduction in fiscal year 1997 and reduces the deficit as a percent of GDP from 5.4% of GDP in fiscal year 1993 to 2.7% of GDP in fiscal year 1997.

Over four years, two-thirds of the gross deficit reduction in the plan goes to deficit reduction, one-third to incentives.

This plan is fair, it is balanced, it is credible, and it is real. There are no accounting gimmicks. There are no rosy scenarios. Indeed, we have used the very conservative economic estimates of the Congressional Budget Office. We have included the full amount of the projected remaining costs of the savings and loan clean-up. There aren't any caps that pretend to cut spending but actually leave decisions for another day. All we did was cut spending in at least 150 ways, and raise revenues. It's all there in black and white, nothing phony, no smoke and mirrors.

And we will propose to enforce the deficit reduction by an extension of the Budget Enforcement Act, with continued caps on discretionary spending, "pay-as-you-go" requirements, and sequesters.

The plan would reduce Federal spending by $247 billion over four years, including defense savings of $76 billion, non-defense discretionary spending cuts of $54 billion, and entitlement reductions of $91 billion, along with savings in interest on the debt. In addition, revenues are increased by $246 billion over four years.

In the fourth year of the plan, spending savings far exceed revenue increases, and that trend would continue into the out-years.

The spending savings in the President's plan are in six general categories: programs that don't work or are no longer needed; eliminating subsidies and wasteful programs and charging fees for government services; managing government for cost-effectiveness and results; controlling health care costs; adjusting defense spending to new post-cold war realities; and asking for shared contribution from all Americans.

Please note that the President has gone first to government to reduce costs in an effort to reduce the deficit. He has ordered cutbacks in the White House staff and throughout the government. He feels strongly that if he is going to ask the American people to change, government must lead the way.

In addition, the plan provides for additional revenues, primarily by ensuring that the wealthy and corporations pay their fair share. The plan also includes a BTU-based energy

tax, which will not only raise revenues to reduce the deficit but also have a positive impact on the environment, while encouraging energy conservation and independence.

Clearly, after requiring government to do its share and asking the wealthy to do their share, the President is asking most of the American people to make a contribution as well. We are counting on all Americans to support us in our efforts to make a better life for our children.

Few of these choices were easy. But this President is determined to talk straight to the American people about our problems.

I want to ask you -- when was the last time a President talked straight to the American people about the budget? When was the last time a President was willing to take on the tough decisions in every area of the budget, not just one or two.

I have sat in budget summit after budget summit, and Mr. Chairman, you have sat there with me. We all know the routine. One side comes into the summit willing to make a few domestic spending cuts but unwilling to reduce defense spending or tax the wealthy. The other side comes to the table willing to cut defense and tax the wealthy, but unwilling to take on domestic spending.

No matter how you may feel about individual components of this budget, you all have to concede that this President has tossed aside the old way of doing things. He has come forward with real spending cuts in both domestic discretionary spending and entitlements, as well as defense. He has also come forward with proposals for increased revenues, with a plan that would collect some two-thirds of the increase from the wealthiest in our society. But he has had the courage -- and the leadership -- to ask all Americans to make a contribution.

This President will not run away from the tough choices. For the sake of our children, for the sake of jobs and long-term growth and higher standards of living for our people, I hope you will join us in making this unprecedented commitment to long-term investment in our economy.

I have a feeling I'm going to hear a lot of complaints this morning about this spending cut or that tax increase. I welcome suggestions. You and I know as well as anyone that this is the beginning of the budget process, not the end.

But if there is a spending cut in this package that you would like to replace, or a tax increase you'd like to delete, please tell me how you are going to replace it. And please be specific -- no artificial spending caps, no gimmicks, no assuming that tax cuts will reduce the deficit. Just keep it straight, and we'll be ready to work with you.

If the Congress enacts this plan, the results will be dramatic. But the reality is that deficits will begin to climb back up toward the end of the decade. The primary reason is skyrocketing health care costs. As a government and as a society, we must reform health care to ensure quality, affordable care for all Americans. Health care costs threaten the security of families, businesses, and government alike. We must act to control health care costs if we hope to control deficits in the long term.

The President will propose major health care reforms within the next few months. Those reforms will be a major piece of the deficit puzzle in the long term.

Mr. Chairman and members of the Committee, in a formal sense we are former colleagues. But we remain colleagues in the sense that we bear the same responsibility to work together on behalf of the American people. I believe we all share the vision of a better life and higher standards of living for our children, that we want to strengthen the economy today to ensure a strong recovery that provides jobs for our people, that we want to reduce budget deficits and their impact on our long-term economic prospects.

We are asking the nation to change. The permanent cost of not changing is far greater than the temporary contribution we ask of all Americans. I ask you to join me in working with President Clinton to achieve this vision of change for our country.

HIGHLIGHTS OF THE PRESIDENT'S ECONOMIC PROGRAM

- Economic Stimulus
  - $ 30 billion stimulus package
  - Job creation: 500,000
  - Down-payment on long-term investment
  - Insurance for the economic recovery

- Long-Term Public Investment for Economic Growth and Jobs
  - Four-year, $160 billion investment plan
    - Rebuild America
    - Lifelong learning
    - Rewarding work
    - Health care
    - Private-sector incentives

- Deficit Reduction to Spur Private Investment for Growth and Jobs
  - Largest in U.S. history
  - $493 billion over four years, $703 billion over five years
  - Two of every three dollars to deficit reduction
  - $140 billion of deficit reduction in FY 1997

HOPE FOR THE FUTURE

- Jobs: 500,000 by 1994; 8,000,000 by 1996

- Targeted Public Investment
  - Infrastructure: $48 billion
  - Lifelong learning: $38 billion
  - Rewarding work: $25 billion
  - Health care: $26 billion

- Renew Private Investment: $60 billion

- Restore Resources Through Deficit Reduction
  - $140 billion in FY 1997
  - Cuts deficit as a percent of GDP in half

- Higher Standard of Living

DEFICIT REDUCTION

	1997	1994-97
▪ Defense	37	76
▪ Nondefense	20	50
– Programs not needed		
– Trim subsidies/ fees for services		
– Management		
– Streamline		
▪ Entitlements	34	76
– Trim subsidies/ fees for services		
– Management		
– Health care		
– Shared contribution		
▪ Revenues	83	246
– Wealthy		
– Corporate		
– Energy		
– Other		

ECONOMIC PROBLEMS

- Short-Term Weakness
  - Slow job growth
  - Debt: household, business, government
  - Weak financial institutions
  - Overbuilt commercial real estate
  - Defense downsizing
  - Corporate downsizings
  - Smaller tax refunds

- Investment Deficit
  - Infrastructure
  - Skills and technology
  - Private investment

- Fiscal Deficit
  - Debt
  - Consequences

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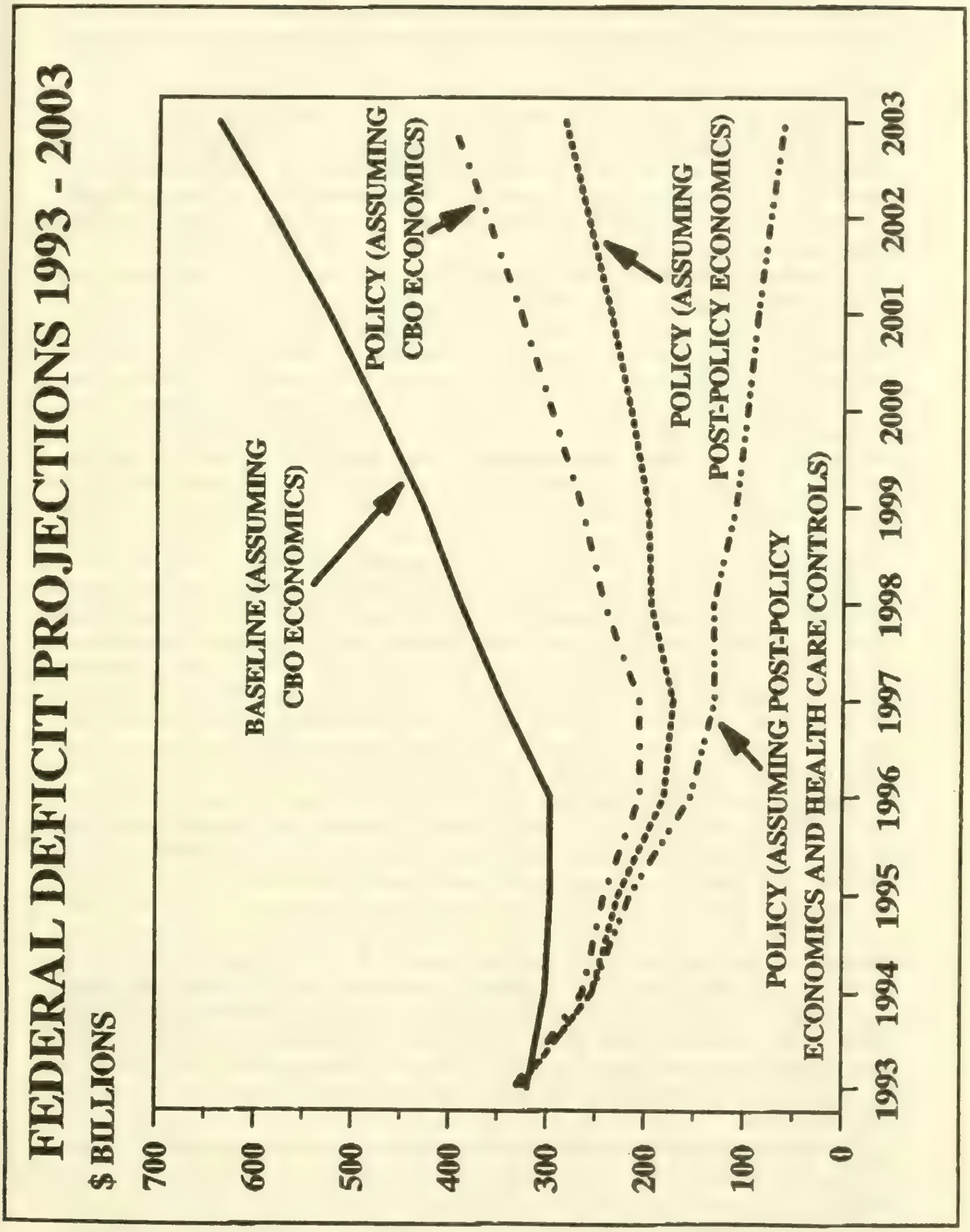

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Chairman ROSTENKOWSKI. I think the point you make with respect to the American people accepting this challenge is a valid one, Mr. Director. You are aware, I am sure, that several of us on this committee, and the Chairman principally, have been subject to a great deal of criticism when we narrowed down our view as to where we ought to cut and where we ought to raise revenues. And this is a very rare occasion, at least in my experience with American people outside the Beltway.

You are absolutely accurate. The people want Washington to get moving and do something, I think, because they recognize that we have fallen behind in our world competitiveness, and unless we do something about the deficit, unless we do something about educating our children, I think that they are afraid we are going to fall even further behind.

Leon, how confident are you in the accuracy of the economic assumptions that are used here?

Mr. PANETTA. Mr. Chairman, the economic assumptions used are the ones that CBO has provided in terms of where the economy is going. We think they are on the conservative side. I think other economists would say they are on the conservative side as well.

The blue chip projections show a much better improvement in terms of the economy, particularly with regard to growth. The projections even of our own economists are more in line with the blue chip predictions about where they think the economy may be headed.

Chairman ROSTENKOWSKI. That is optimistic, then, isn't it?

Mr. PANETTA. So there is some hope here, I think, that everybody thinks the economy ultimately can do much better, but, again, our view was that we ought to take conservative assumptions about where the economy is going so that we don't overstate where we think we are going with the deficit. If we can make these decisions with regard to deficit reduction, then I think it is going to mean that we are going to be in an even better situation in terms of the economy if we can secure those savings.

Chairman ROSTENKOWSKI. Well, I for one am a great believer in the deliberative process of legislating. We are all aware here that in 1985, when the administration suggested that we have a tax bullet, and that it was going to take us 3 or 4 months, it took us damn near 12.

I believe in the legislative process and the participation of all people whose voices want to be heard. But this is one occasion, however, where I think we have the momentum. I think the people are ahead of us. And I wish that those conservative pangs weren't there, but we are going to process this legislation, and I hope that the administration is agreeable to some changes that will need to be made. I am hopeful that they will be agreed upon with the administration.

Do you envision any additional spending cuts or revenues to fund other administration initiatives such as health care and welfare reform?

Mr. PANETTA. Obviously, our first goal here is to try to meet the targets in the economic plan. We think that is the key.

And our first order of business is to try to get that economic plan in place. That economic plan and the principles behind that plan

include several important elements. One is, obviously, the stimulus package which the President feels very strongly about. We are going to be seeing some additional defense cuts over this next week with regard to base closures, continuing contractions that are going to be part of that. Plus what is happening with regard to corporations and companies just tells us that we have to provide some insurance about where the economic recovery is going and the stimulus package does that.

Secondly, we have got to make some investments, retargeted investments for the future in areas like infrastructure and highways. We have got to deal with problems related to working families in this country as well as private sector initiatives.

And, thirdly, that we do the deficit reduction.

Now, the elements that we have as part of this deficit reduction package are the ones that we think are important to protect as we move forward, as to whether or not we will need to look at additional revenues or additional cuts when we deal with health care reform, when we deal with other issues down the road. Because one of the things we are calling for is a continued pay-as-you-go requirement.

I want to make this point to the members of this committee that we intend to pursue the same enforcement tools that are part of the budget agreement. We are going to establish caps on discretionary spending. We are going to establish pay-as-you-go requirements. We are going to establish sequester as the teeth to make this happen. And we are also going to support an enhanced rescission proposal that will give the President the ability to send his rescissions to the Congress and have those voted on by both the House and the Senate. So we are going to have some tough enforcement tools.

As to whether or not—as other proposals come, I think we need to look at those individually.

On health care reform, obviously, a lot of that depends on the nature of what is presented in health care reform. I can't tell you what that looks like because, obviously, the task force is working on that. There are a lot of different views as to whether or not additional revenues will be necessary or not. But, clearly, I think, as we deal with those issues, the administration is going to want to work with this committee to focus on whether we have got to provide funding for it.

But I can tell you this, that the fundamental approach that the administration is going to take is that there ought not be any expansions, that there ought not to be any additional entitlement benefits unless they are paid for. Period.

Chairman ROSTENKOWSKI. Well, Mr. Director, I have been chairman of this committee now for a little better than 12 years, and I think in 1980 we established in this committee, even before it was an idea of the budget process, that we pay for everything that we want to move. And so it doesn't come to us as any surprise that—and we appreciate the fact that the administration is going to adopt that same policy. I think that that is exactly what we should be doing, paying for things as we want to enact them.

Thank you very much.

Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Director, first of all, I welcome you back. I look forward to working with you. I am going to help you and the President get your program enacted.

And I want to know what you think the time schedule should be. When do you want us to complete our action here in the Congress—first, on the stimulus package; second, on the longer term package? What are your deadlines in your own mind?

Mr. PANETTA. Well, Congressman Gibbons, obviously our concern is that we try to expedite action with regard to the economic plan.

Mr. GIBBONS. That is agreed to.

Mr. PANETTA. That is important. I think we have a window of opportunity here, and we have to move. If we don't—you know, as I have said, you can always die the death of a thousand bites in this business as people pick away at you with different lines of attack. And, particularly with the large number of special interests that are going to be involved in opposing various sections of this, we are concerned that it has got to move as quickly as it can.

We think it is important that the budget resolution move first, and the committees are now going to be marking that up. We understand that the House Budget Committee will do their mark tomorrow. We understand the Senate Budget Committee will mark up this week. We think that is the right time frame.

They are going to bring the budget resolutions to the Floor, hopefully, the next week. We would want the budget resolutions voted on first in both the House and the Senate to show that the Congress is committed to the deficit reduction portions of this plan as well as the broader elements of the economic plan, follow that, hopefully, with a vote on the stimulus package.

Mr. GIBBONS. By when? Give me some dates.

Mr. PANETTA. I would like all of this, hopefully, to be adopted before the Easter break.

Mr. GIBBONS. You are talking about the budget resolution and the stimulus package?

Mr. PANETTA. That is correct. We would like to see both the budget resolutions adopted and the stimulus package put in place before the Easter break.

Mr. GIBBONS. All right. Now, how about the longer term tax increases, all of those, when do you want us to have that done?

Mr. PANETTA. We think it is appropriate, then, if you have a budget resolution passed before the Easter break, there is no reason why, after you come back from the Easter break, you can't begin the immediate work on reconciliation which implements the budget resolution. And the hope would be, then, that you could expedite—the committees of the Congress could expedite their work on reconciliation, and we would try to see if we could get a vote hopefully sometime in either late May or June on a reconciliation package and try to do the same a little later in the Senate, but try to ultimately wrap up a package some time between July 4 and the August break.

Mr. GIBBONS. When you say the reconciliation package, you mean all the changes that the Ways and Means Committee will have to grant in tax and spending cuts?

Mr. PANETTA. That is correct. There are a number of committees, as you know, in the process. The budget resolution includes reconciliation instructions to all of the committees.

The committees involved here would include not only Ways and Means but Agriculture, Energy and Commerce, Post Office and Civil Service, Armed Services, a number of committees. They will then have to report their element of reconciliation, and that is a process we hope can start right after the Easter break.

Mr. GIBBONS. So you want us by the Easter break to have done the stimulus package, is that right?

Mr. PANETTA. That is correct. If we don't get the stimulus package in place soon, we are not going to be able to move the kind of jobs out there that the President is interested in doing. It has got to be—we want to put these jobs on a fast time track. That is the key to a stimulus package.

Mr. GIBBONS. And the reconciliation by what date?

Mr. PANETTA. Reconciliation, we hope, would be done and completed by some time between the July 4 and August breaks. It is a fast timetable.

Mr. GIBBONS. It is. But I agree with you. It has to be moved fast or the stimulus package will be obsolete.

Mr. PANETTA. That is correct.

Mr. GIBBONS. It will be too late to do anything about it. Well, I am onboard with you. Let's go.

Chairman ROSTENKOWSKI. Mr. Shaw will inquire.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to add my congratulations and support to you as the new Budget Director. From your opening statement, even though it didn't have specific elements, I sort of heard you saying you are going to be a kinder, gentler Dick Darman.

So, with that in mind, I would like to inquire, if I may, on the lateness of this budget document. From a historical standpoint, it has always been the President's responsibility to submit a budget to the Congress, as I understand it. The Congress didn't necessarily even respond to it, but it provides a guideline that it would work with. In fact, there wasn't even a Budget Committee in the House until recent years. Can you ever remember having, as chairman of the Budget Committee, ever having gone to a Budget resolution markup without the benefit of the President's budget?

Mr. PANETTA. Absolutely. We did that in the budget agreement when we went to the budget—when we had the budget agreement worked out in 1990, we worked with, basically, the various elements that were agreed upon by those participants in that summit, and we then incorporated that in the budget resolution and in reconciliation.

Mr. SHAW. But that was a different process. It took place after the administration's budget was received up on the Hill, as I recall. Now, you were an integral part of the 1990 agreement. You can correct me if I am wrong on that statement, but my question is made in context of the budget that is traditionally received at the beginning of the year for consideration by the Congress.

Mr. PANETTA. Well, you asked me if we had ever marked up a budget resolution based on something less than a full budget, and the answer to that is yes.

Mr. SHAW. Yes, but that was after a budget agreement had been reached together with the Congress.

Mr. PANETTA. I have to tell you, that was a $500 billion budget agreement that included decisions on entitlements. It included decisions on defense. It included decisions on caps. It included decisions on taxes. And we put together a budget resolution based on what was agreed to at that time.

Mr. SHAW. Well, I think you know what I am talking about. I am talking about the President's own budget, the budget that is traditionally received in February of that year, and I believe that the President's budget for that year was received in February of 1990, long before the budget agreement was negotiated. The budget agreement was a summit that was called by the President in cooperation with the Members of Congress to try to solve some of our immediate financial problems. So it was actually supplementing the budget that the House had received and the document that the House had received from the administration in February previous to the summit agreement.

Mr. PANETTA. To respond to your question, this document is roughly 150 pages long. Everything you need to put together in a budget resolution, everything and more is contained in this document.

Mr. SHAW. Well, I would certainly disagree with that. Those are certainly not the details that the Congress traditionally has to work with. I know the book you are holding up.

Mr. PANETTA. That is just not true. Let me tell you, as chairman of the Budget Committee, look at the back tables here. Every one of these tables tells you exactly what is involved in mandatory savings, exactly what is involved in nondefense savings, line item by line item. It includes overall caps in terms of what we want on discretionary spending. It includes what we are presenting on investments, what we are presenting on stimulus, in particulars it provides every element you need for the budget resolution.

In addition to that, I can assure you by the end of March we are going to be providing a line item by line item, you know, for each of the departments. But that is more for the Appropriations Committees, very frankly, than it is for the budget process. We are providing more than enough information for the Budget Committee to put together a budget resolution.

Mr. SHAW. Let me reclaim my time because I do want to get specific in one particular area that I am tremendously interested in.

Fred Grandy and I asked the President a question about welfare reform after he came up and met with the Republican members of this committee.

In August, he announced a plan which he has mentioned since then on time limiting AFDC payments. There is a cost to his program. His program is almost identical to the one that the Republicans on the Human Resources Subcommittee had mapped out in a paper and drafted into legislation long before the President made his statement last summer.

I consider this a remarkable opportunity to work with a Democratic President as I think he is going to need Republicans working with him on this particular issue. I don't see—and this is the first time I have seen this document—I don't see a mention of it in here.

I don't believe there is anything in the document that you were holding up a minute ago, with regard to welfare reform. My question is, have you worked out numbers for that and is that something that you are looking to work out this year?

The President mentioned to me that he was going to be putting together some type of legislation within the next few weeks, and he also indicated that he wanted the Republicans to participate in the drafting of that type of legislation.

Mr. PANETTA. Well, the President, as he indicated to you, is committed to working on welfare reform. There is a group that has begun the process of doing that. It is going to have to be on a pay-as-you-go approach. We have not made any room in the budget specifically with regard to welfare reform because our recommendation, obviously, is that, as you develop the various elements of welfare reform, we are going to have to find ways to pay for those elements within the context of welfare reform itself. So it is not, obviously, part and parcel of the proposal that we have presented here because it is something that the President wants to present essentially on a separate track with a separate proposal involved in welfare reform that, hopefully, will be worked out by both parties.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Panetta, it is good to see you. It is a joy to work with you. You cannot say that about every Budget Director, but in your case it is really a joy. I have three specific questions for you, and they are general in nature, but I think they go to the philosophy of any budget, so let me ask you the first question.

In the most recent annual report, the Pension Benefit Guaranty Corporation has a deficit now of about $2.7 billion. That is up over $1 billion. Also there are unfunded liabilities of some $40 to $50 billion. Now, we know that the fear is, ultimately, those losses are going to fall on the taxpayer if something isn't done about it. I think there is general agreement about it.

My question to you: Would the administration object to including reconciliation instructions in the present budget to say to each committee of jurisdiction that you have got approximately 5 years to correct this imbalance? What would be the position of the administration with respect to the PBGC?

Mr. PANETTA. Thank you very much, Congressman Pickle, for that question because it is a concern I know you have had. And I discussed this with you when I was chairman of the Budget Committee, and I have developed even greater concerns about this issue as Director of the Office of Management and Budget.

I have issued a memorandum to the Secretary of Labor, Mr. Reich, who I believe has begun to put together a task force on this issue. And I have asked that they develop very quickly, with the cooperation of OMB, first, an analysis of the situation, but, secondly, then recommendations as to how to correct the situation with regard to the Pension Guaranty funds. And I have asked them to do that within the next 60 to 90 days so that we, hopefully, can consider incorporating the recommendations of that task force in reconciliation proposals.

Mr. PICKLE. Well, that is encouraging. Thank you very much.

Now let me go to another subject, and that is another vexing problem that pertains to Government-sponsored enterprises. We have experienced massive Federal losses in recent years; a few years ago in the housing sector, but before that in student loans and the farm credit system. We create them because it is ready cash and it is not on the budget. The lure of these programs is that they are off budget. We don't have to account for them. But they come back face to face with the taxpayers. We have just experienced a terrible loss in the S&L field.

So, I personally am concerned that, at this particular time in Federal budget tightening, in order to have some ready cash, we may create more of these agencies and pay for them later. I don't accuse you of that, but I have that constant concern. So my question to you is, do you favor the creation of these additional Government-sponsored enterprises in almost any area right now?

Mr. PANETTA. As to additional ones or to——

Mr. PICKLE. Well, any additional ones. First, we have got to tighten up the present ones.

Mr. PANETTA. I think the first order of business is to make sure that with—I think we have implemented, obviously, credit reform proposals that are very important. I think we did that over the last few years. They have been helpful, but I think more needs to be done to ensure that these Government-sponsored enterprises maintain adequate balances and don't get into a situation where we could face another S&L crisis. So we are looking at all of those right now.

I would just say to you I am not particularly anxious to establish any additional ones at this time because I think we have got to get a handle on the ones that are there right now.

Mr. PICKLE. I noticed that the President recommended possibly taking money from these big pension funds who had cash and creating another GSE to give credits to them if we use their cash. That gets awful complicated. I hope we don't get into that area.

Mr. PANETTA. We are not looking at anything along those lines at this time.

Mr. PICKLE. All right.

The last question would be this: According to an article in Newsweek, the over-85 age population is going to double between 1990 and 2010. Those over 85 will have medical expenses that are higher than any others. Now, as I recall, as Budget chairman, in the past you have said that the only way to really make a dent in the deficit is to restructure entitlement spending. Is that still your position?

Mr. PANETTA. Without question, because there is no way you can deal with this issue without dealing with entitlements. Entitlements make up 50 percent of the Federal budget, in excess of $700 billion. Fifty percent of those entitlements are in various retirement programs, including Social Security; 30 percent are in health care programs. The balance of the 20 percent are in agriculture, in veterans programs, and in programs that serve the poor We have seen tremendous growth in all of those entitlements, but in particular in the health care area. So, if you want to get a handle on where the deficit is headed there is no question that you have to confront the entitlement issues.

Let me just say that our economic plan—we rely on the agriculture programs for savings. We get savings from veterans programs. We get savings clearly from health care with our Medicare proposals, almost $40 billion. In addition to that, we include retirees, particularly Social Security recipients, lifting their benefit levels subject to taxation from 50 percent to 85 percent. So we think we have touched all of the areas that have to be touched.

Mr. PICKLE. Mr. Panetta, you have touched them, but we are faced with realistic questions. You want to restructure them. I would like to know, specifically, how would you restructure them and what is the administration going to do? How can we start working on it? Because that has to be faced. You are making some savings, I recognize that. But we may, over the 10-year period, just be kind of holding even which would be a great accomplishment in itself. If we got to do the restructuring, we better start on it.

If you have any plan, I think we would like to work with you because most of that will be done through this committee.

Chairman ROSTENKOWSKI. Mr. Jacobs.

Mr. JACOBS. Leon, why does President Clinton need a much larger staff than President Carter did?

Mr. PANETTA. I think the proposal that was made to reduce the White House staff is a proposal that the President has implemented, and I think he is trying, basically, to work within the constraints that he has established for the rest of the Departments.

Mr. JACOBS. But he ends up with a larger staff than Carter had.

Mr. PANETTA. I am not sure that is true because I don't know the numbers. But I have to tell you we are putting some cuts in place that are hitting almost every agency.

Mr. JACOBS. I don't say that in a hostile or carping way. In the novel Dr. Zhivago, the revolutionary war hero, Stralnikov, roars by in a locomotive and the peasants shout his name in adulation, they shout "Stralnikov." And one lady says to the other, "they say he eats the same rations as his men."

Now, I will concede that, apparently, the President eats the same rations as most people who go to McDonald's, but in a larger sense I think the staff could be still smaller and give greater credibility to the President's eloquence in calling for contribution or sacrifice to the solution of problems. I think the pencil ought to be sharpened just a little bit. Just pass that along.

Mr. PANETTA. We are still working on that.

Mr. JACOBS. I hope so. You are not considered on the White House staff, are you?

I don't mean to go from preaching to meddling. Isn't it true that the GAO has fairly consistently formed a low opinion of investment tax credits through the years?

Mr. PANETTA. I don't know the answer to that.

Mr. JACOBS. I think you will find that it probably has. I know that the President's proposal isn't a plenary across-the-board investment tax credit. As I read the GAO reports, they have concluded that, in cases where companies didn't plan to buy equipment but were induced or enticed to do so, it was possibly a waste of resources. And in other cases, where companies did plan to buy the equipment, it turned out to be windfalls. I don't know the answer, and I don't mean to imply that I won't support the proposal,

but I think some explanation of why this differs from what the GAO has opined in the past would be very helpful.

Mr. PANETTA. Congressman, I am not particularly familiar with GAO's response to this issue. I know that there are the kind of concerns that you have indicated with regard to how the investment tax credit works and whether or not it can be abused.

The reason we approach the investment tax credit here is, basically, to try to implement on a temporary basis the tax credit for 1993 and 1994 as a way to try to move some immediate investments into the economy as part of the stimulus effort to try to get the economy going. And the President felt strongly about that, that the investment tax credit was the one area that could probably send that message better than other areas that were being discussed. So that is why we kept it on a temporary basis, and that is why we moved to a small business incremental tax credit, more permanent incremental tax credit for small businesses in the long run.

Mr. JACOBS. Let me finally compliment the administration on the part of its proposal. There has been a lot of propaganda, "figures never lie," but—"et cetera, et cetera"—about what happened in the 1980s with the income tax. A couple of plain facts are that, following the 1981 tax cut, one of the most prominent military contractors with the U.S. Government had a cumulative economic profit in 3 years time of about $20 billion—that is the big "B"—billion dollars—and paid zero income tax on it, largely as a consequence of the 1981 act.

It is equally true that the 1986 act, which did some good on the reform side, did much harm, I think, on the equity side. An individual with $20 million taxable income would have paid $8 million tax before the act was passed, and paid $4 million afterward. I have a specific individual in mind. While I won't give his name, his initials are Lee Iacocca.

Therefore, I compliment the administration for trying to play a little bit of catch-up ball for the ordinary citizens of this country. You had a situation where people at the top were living very well, getting big tax cuts. It sets a bad example down the line for sacrifice and public spirit and caring about your country.

Thank you.

Chairman ROSTENKOWSKI. Mr. Bunning will inquire.

Mr. BUNNING. Thank you, Mr. Chairman.

Good to see you, Leon. I would like to follow up on something that you talked to Clay Shaw about. You held up a document, the budget document, and you said there was everything in it that was needed to mark up a budget resolution. Is it true or is it not true that Senator Domenici has requested 15 additional documents that are required by law that weren't in the budget document that you held up?

Mr. PANETTA. I think Senator Domenici has asked for additional information, and we are providing additional information to him. But it is not—I would argue that it is not necessary to do a budget resolution.

Mr. BUNNING. No, but you said everything that was in it that was needed. But, in fact, there were 15 specific items that were required by law in the budget because they are needed to mark up

the budget resolution. They are not in this document and, therefore, he has requested those items and you are complying; correct?

Mr. PANETTA. I think the distinction here is that in our fuller budget we are going to present on a line-item-by-line-item basis, we are going to meet all of that information request. That relates to the appropriations process.

To do a budget resolution, which, basically, is functional totals along with reconciliation instructions, everything that is needed is in this document.

Mr. BUNNING. All right. You, also, in speaking to someone earlier, talked about the pay-as-you-go aspects of this administration. I would like to understand more fully the $5.7 billion that we added on to the budget deficit in 1993 for the unemployment compensation bill that the administration insisted be passed without financing. We offered in this committee alternatives to pay for it, and to do those things that we thought were more compassionate and necessary to continue unemployment compensation to the unemployed and yet follow the law that you supported last July. Can you explain that to us?

Mr. PANETTA. Sure. I think the tools that we want to implement as part of this budget are exactly the same tools that were part of the budget agreement. The budget agreement said that if the President and Congress feel there is an emergency with regard to certain elements that we ought to be able to move those proposals as an exception to the pay-as-you-go requirement. The President feels strongly that this is an emergency situation with regard to dealing with the unemployed in this country, and that is the reason he sent it up on that basis.

Mr. BUNNING. But the bill that we passed, obviously, was supposed to preempt any need, according to our new Secretary of the Treasury, ever to do what we just did, that is, to declare an emergency and add to the deficit. In other words, to let the states implement their unemployment compensation and allow the Federal Government to come in and pay for 50 percent of it. If the Federal Government preempts the states from doing that, then we will never have the states implement the triggers that we put in the bill last July.

Mr. PANETTA. Again, our view on that proposal, as it is with the stimulus proposal, is that we have got to move these provisions into place quickly, to try to deal with some very urgent needs within our economy, and that ultimately the package, if you pass the full deficit reduction package that includes close to $500 billion in deficit reduction over 5 years, that we will more than pay for the impact of the stimulus package as well as all of the investments by that time.

Mr. BUNNING. Well, I wish I could believe that were true, and that we would be reducing the deficit that much in the 5th year. But I have been here for 6 years now, and, unfortunately, we always increase the deficit in the first 2 years of a budget agreement. Then the cuts that are supposed to be coming in the 3rd, 4th and 5th years, obviously, never occurred, to reduce the deficit. It just keeps climbing.

We imposed the caps in the 1990 budget agreement that you helped to negotiate. I just hope that the caps stay and that we

don't continue to punch holes in them like we did for the unemployment compensation. For that matter, I worry about the current proposals for year 1 and year 2 of the administration's budget proposal doing damage to the caps.

Mr. PANETTA. Well, that was the reason, Congressman, why we wanted to stay in the stimulus package along with unemployment comp below the caps established by the budget agreement, and we do. Nothing in the stimulus package, nothing in the unemployment compensation piece in any way breaches the caps in terms of overall discretionary spending established by the budget agreement.

Mr. BUNNING. Except that it moves them from one to another.

Mr. PANETTA. Well, except that what we had was we had a surplus in defense last year, and the surplus in defense gave us about a $16 billion cushion. That $16 billion we feel is now being used for purposes of providing a stimulus in the economy, but it doesn't breach the overall cap established under the budget agreement.

Mr. BUNNING. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

First, Mr. Director, I would like to thank you for the help you have given the committee and the subcommittee in the area of family preservation. I know that you have been working on that, and we appreciate it very much.

I just might make a couple observations before I ask my question. In terms of the unemployment insurance extension package, as we all know, approximately 330,000 Americans each month are losing their unemployment benefits, and these are the people we have been trying to assist and help. Of course, that money will go into the economy, just as it did in 1981 when we talked about supply side economics, that this will help the stimulation of the economy. That is why it is part of the stimulus package.

I believe those who are looking at these issues should not look at it with blinders, that is, each event as a separate event, but the President's package must be looked at in its entirety. That is where the deficit reduction will come into place, and we hope that the Members on the other side of the aisle will end up supporting the deficit reduction package in the month of July before the August recess.

I might just further add that, in terms of the timetable that you and the President and others are working on, this will be consistent with 1981 when the Reagan economic package was passed, when we complete the reconciliation package before the August recess.

I would like to ask a question in terms of the welfare issue, and I know that you are all working on this, and I know the intergovernmental working group that the President has set up, will be soon working on the welfare issue.

In terms of health care, Leon, I know we could get additional revenues in order to deal with the uncompensated care either through sin tax increase, particularly tobacco or other ways, because people really want to deal with this issue. And, obviously, there are going to be benefits and additional revenues that will be needed to offset the political problems we have. But, in terms of

welfare, we are talking about, in addition to the time limits, the 2 years and you are out, but a whole infrastructure that must be developed.

And I understand why it would not be in this package because we are not anywhere near coming up with a formulation of what this package should be. But in terms of the pay-as-you-go problem, I don't know where we get the additional revenues for the job training, the education component, and the guaranteed jobs. And certainly it will be very difficult to ask the taxpayers to pay for this, again for political reasons because, you know, how do you get suburban America to pay for somebody who is on welfare in the inner cities?

And you may not be able to answer this question at this time, but somehow we have to make sure we deal with this because I wouldn't want a situation where we talk about 2 years and you are out, and that becoming the welfare program of the Clinton administration because that is not a welfare solution when we are talking about job training and we are talking about independence for these people rather than dependency.

So if you could look at this maybe you might have comments now on this, but if you have some thoughts later, that would be appreciated.

Mr. PANETTA. Well, you obviously, having worked on this issue before, recognize the kind of challenges we face as you try to package together a comprehensive welfare reform proposal. The hope—ultimately, I think the hope of everyone who agrees on the need for welfare reform is that what you are going to do ultimately is decrease dependency on these programs, not increase, but decrease the dependency on these programs. I mean, my God, right now we have got, what, 26 million Americans on food stamps in this country. We are seeing a dramatic increase with regard to other programs that serve the poor.

My experience has been when I have visited soup kitchens and food pantries is that most people I talk to don't want welfare, they want a job. And that is, I think, the main thrust of this economic plan and the main thrust of any welfare reform has to be to try to develop that.

I recognize that there are probably some short-term costs that are going to be involved in any proposal like that. You have got to do the job training. You have got to do the job placement. You have got to get people into meaningful jobs. As to how we do that, what kind of savings we can get from overall welfare reform, I think that is the kind of issue we need to look at as we develop a proposal that the administration can support.

Mr. MATSUI. In terms of the child support enforcement part of it, I know this is in your package now, and it is more than likely that the committee and the subcommittee will try to move both the child support enforcement and the welfare in the same track, and that may help raise some revenues, although not enough to pay for the infrastructure needs.

Mr. PANETTA. I appreciate that. As I have indicated to this chairman and I will indicate to the chairmen of the other committees, I think we have to provide flexibility in the committees as they deal with reconciliation to allow them, obviously, to meet the sav-

ings targets but to be able to adjust some of these proposals so that they meet other priorities that they are working on.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

Welcome. There has been an interesting dynamic, at least so far. I haven't heard any basic challenge to the thrust of the Clinton program, and it may be coming later on at this hearing, but I think it may well be because the basic thrust is on target. We acted for years around here as if there was no real problem when we all knew there was one. And this deficit is an albatross.

A couple days after the President addressed us, Leon, I went home and held an impromptu town meeting in Macomb County, which is kind of a bellwether part of this Nation. The local paper summed up the reaction. About 300 people were there. Without mail notices, et cetera, just a notice in two newspapers, 300 people were there. It was a lively meeting, and the local newspaper summed it up this way: That the people who were in attendance want to see Congress implement Federal spending cuts before they reach into taxpayers' wallets.

By the way, we will be holding further town meetings in April. It would be great—I don't know—if you have the time, you could stop in. Because I hope you have the credibility as I do to respond. I would like you to take that right on and just tell us, tell the country what you are thinking in terms of the importance of Federal spending cuts before Congress or the White House reaches into taxpayers' wallets for more taxes.

Mr. PANETTA. I have—as I indicated in my first statement, I have always believed that there is no way you can confront the problem that faces this country on the deficit and not do a balanced package. It has to be.

I mean, if you try to say this is all going to be done on the spending cut side, you are not going to raise any revenues, you can't do it. On the other hand, if you say you can do it all by revenues and you can't do it by any cuts, you can't do that, either. It has got to be a balanced package because we are dealing now with a situation, the deficit, that all of you know is intolerable. We are headed towards a cliff in this country if we don't confront this issue.

So what the President felt was important to do was to say, look, we have got to put on the table some very direct specific spending cuts, and we also have to include some revenues as part of that package.

Now, let me just tell what you we did on the spending side. On the spending side we have looked at every area. There isn't an area here that has gone untouched. On defense spending, we are looking at almost $112 billion in defense reductions. Now, obviously, some critics of the plan would say that is probably too much in defense, but we think that is in line with where we need to go considering the changes that are taking place in the world situation.

Secondly, on nondefense, we have almost $76 billion here on nondefense spending. My understanding is that the committees of the budget on both the House and the Senate sides are looking at additional savings in nondefense. But if you take those nondefense savings further, you begin to have an impact on education, on

transportation, on the kinds of priorities that I think all of us are concerned about. So I am not sure there is a lot more room there.

On entitlements, we have included every area. In agriculture, we are getting criticism that we have done too much in agriculture, but we have trimmed those subsidies; and we have included veterans programs, health care programs, and retirees with the recommendation of the Social Security tax.

And I think the bottom line is this: If you are asking farmers to make a contribution, if you are asking veterans, if you are asking doctors, if you are asking hospitals, if you are asking the elderly, if you are asking working families to make a contribution, then why can't we ask the wealthiest in this country to also make a contribution? And that is why we come forward with a revenue proposal that says 70 percent of the revenues ought to come from the wealthiest families in this country, so that they, too, participate in this effort. There is nothing wrong with that. And so that is the kind of balanced package we have tried to present to the country, and we think it is right.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman.

Leon, welcome. I think I would like to preface my remarks by saying I may be the only member of the Ways and Means Committee that has had Leon Panetta support one of my deficit cutting amendments. You may recall back in days of drought when we were on the Ag Committee, and I proposed the amendment that would have limited the amount of disaster assistance from the commodity programs. It would not have passed the Ag Committee had you not supported it.

So I think that we are of the same mind when it comes to talking about fair downsizing of these programs. I am concerned when I hear you make statements about fairness and downsizing everybody equally. Then I pursue the details of your program and there are some inconsistencies that I want to use my time to address. I have talked to you about these privately, so this is no surprise.

I want to go immediately to the cumulative 525 percent effective tax increase on one commercial industry, which in this case would be barge traffic up and down our inland waterways. In your budget it is projected to produce savings of $820 million. Now, my problem is the cumulative effect of this tax is greater than you are aware of and perhaps your colleagues in the administration are.

I am not going to quibble with the need to cut programs. I submitted my own budget proposal to the Iowa, and Nebraska press and cut your programs even further. But I would submit this. If you begin to raise by a dollar the inland waterway tax, you are not only taxing producers and ag businesses once, you are taxing them twice. Because, in my town of Sioux City, for example, you will see barges coming up the river which deliver fertilizer and agriculture inputs. The cost of that transportation will be added to the cost the farmer must put into his farm to grow his crop. At the same time you will be taxing him to take that commodity away down the river and will increase the amount of money the farmer must pay for transportation and thereby decrease his commodity.

At the same time you are now proposing, after having what we thought was a victory on getting a one pound waiver on ethanol, that ethanol should be taxed under the Btu formula.

I am having a hard time finding fairness in this particular scenario. I believe agriculture should be downsized like everything else. I am not going to sit here like our colleagues on the Ag Committee and show you the little blue line and all of the disproportional cuts that agriculture is taking. You know all that stuff.

I am just asking, when waterways are used for recreational purposes and flood control and municipal power supplies as well as commercial uses, why aren't the costs shared?

And, second, we have heard that the President said he would reconsider the inland waterway fee/tax. This, I think, passes the Darman duck test. I think this is a real waddler here, Leon. But what is the status of this policy change? Can we see some light at the end of this tunnel?

Out of all the agriculture cuts that you have proposed, and I have told you this privately, I think this is the most insidious because it layers in costs that you cannot predict as the Budget chairman, or that Robert Reischauer probably cannot see as the CBO Director but that farmers will know of almost instantly. I just wanted to get your feeling on this because this is, I think, a potential dam breaker in terms of ag subsidies.

Mr. PANETTA. Well, obviously, this is a proposal that we want to work with the committees on as we try to look at the concerns that you have reflected, others have reflected with regard to these issues.

But I have to go back to the basic point. When you are looking at fairness, the question is, is it fair to the average taxpayer in this country? And when you look at inland waterways, inland waterways are the most heavily subsidized form of commercial freight transportation in the country. They are. As a matter of fact, 70 percent of the construction costs in these inland waterways are borne by general revenues, by the general taxpayers. We don't even get enough out of these fees right now to cover O & M costs. And so isn't it fair, if it is going to be the most heavily subsidized form of travel, that we at least get a little bit back to try to cover some of these costs?

Mr. GRANDY. Well, if you are going to subsidize the fees, why don't you subsidize all use, the recreational use, the flood control—if you are going to tax it. You are zercing in on one player.

Mr. PANETTA. We are recommending fees on recreation areas. We are recommending fees on national parks. We are recommending fees across the board because we think that, when it comes to the cost of the Federal Government and we provide services like the inland waterways, we ought to have those costs at least covered to some extent. This isn't going to cover all of our cost, but at least it is going to cover a little more. How do you approach this business of trying to trim subsidies and again trying to cover these costs unless you put everybody in the same ball park?

Mr. GRANDY. My concern is you are indirectly taking the barge traffic and using that subsidy to cross-subsidize railroads. In my part of the country, that is what will happen. There will be a shift. Many of the grain dealers and farmers and grain elevators out

there depend on railroads and cannot acquire the hopper cars to move their grain. They are held hostage by the railroad. This will drive up their dependency on the railroads.

So I am not going to argue your numbers about how heavily the commercial barge traffic is subsidized. I don't have the numbers in front of me, so I can't review what you are saying. I am just saying that I think your intention here may be admirable. I think your implementation is going to produce a consequence that you don't want, not as a former Member of Congress and not as the Director of the Budget for the Clinton administration.

Mr. PANETTA. I hear what you are saying, and I want to work with you to try to see if there is a way to refine it.

Mr. GRANDY. I appreciate it.

Chairman ROSTENKOWSKI. Mr. Cardin will inquire.

Mr. CARDIN. Leon, welcome to the committee. It is a pleasure to have you here. I offer my congratulations to you and the Clinton administration for coming forward with the bold, courageous plan to deal with our economy and to deal with the deficit.

I would like to talk about a couple of points in the time that I have. First, the Medicare cuts that you have in your proposal. I have a great deal of concern with the Medicare cuts that you are proposing. Not that we don't have to have savings in Medicare. We need to. I look at your proposals as a downpayment on health care reform that will, hopefully, get control of all health care expenditures, both public and private.

But I would at least like your comments as to the dangers that we might, by dealing with the Medicare budget alone, be just shifting some additional costs to the private sector which will certainly not help our economy, and what type of comfort level you can give us that we are sincere in dealing with the overall health care costs of this country and not just the public sector costs in health care.

Mr. PANETTA. Ben, I have to tell you, if there is one issue that I have heard the President emphasize time and time and time and time again, it is the need for comprehensive health care reform. Because I think he views it as essential to the overall economic plan to try to meet goals that he is after.

And, as you know, we will reduce the deficit significantly with this plan if we put it in place. We will get it down to roughly half of the deficit to GDP ratio that we now have, from 5.4 to about 2.7 percent, get it down, grind it down from about $350 billion in terms of annual deficits cut to around $200 billion. But no matter how far you bring it down, even if you get the deficit to below $200 billion in four or five years, the deficit starts to climb back up because of health care costs. As you know, it is a tripling of health care costs.

So the President feels that if you, in fact, are going to put us on a path, we are going to put the country on a path to gradually get that deficit down, on a permanent basis, we have got to do health care reform. And, as part of health care reform, you have to do cost constraints. You can't just do health care reform without looking at cost constraints. So his view is that whatever we do on Medicare savings is, in fact, a down payment, and that health care reform will prevent the kind of cost shifting that we have seen in the past.

Mr. CARDIN. We need a health care reform proposal that will restrain both the public and private expenditures. As you know, Medicare today on average for hospital care pays about 90 percent of the costs, whereas those private insured people are paying a higher percentage of the cost, and you have cost shifting. We certainly don't want to continue that. Instead, we need to bring it closer together where, hopefully, everyone pays towards the cost of medical care equally without having the cost shifting that is currently occurring. It seems to me that, ultimately, we have to address that issue.

Let me raise a second point. Your proposal is real, what it asks in the deficit. I applaud you for that. There has been criticism that we need to do more in spending cuts, and I agree we need to do more in spending cuts. The President's challenge to us said be specific. Now it looks like our budget document will reflect additional spending cuts that Congress will be committed to achieve and the administration agrees to work with us.

I would just hope that you will monitor exactly what comes out of our Appropriation Committees to make sure that what we say we are going to do will be real cuts and that the administration will not go along with any accounting shifts or gimmicks that appear to cut spending but in reality will not achieve the dollars that we are talking about.

Mr. PANETTA. Obviously, having spilled all of the blood that we are going to have to do to get an economic plan in place that is honest and direct, I don't think the President is about to let it erode then in the appropriations process if there are games that are played that we try to keep out of the budget proposal itself. So we are going to be monitoring, obviously, the appropriations recommendations to ensure that they don't build in the kind of gimmicks that could ultimately erode the deficit reduction in the outyears. That is something—that is one of the reasons why he would like to have this enhanced rescission power, is the ability to be able to control that kind of process once we put the economic plan in place.

Mr. CARDIN. Thank you. I look forward to working with you.

Chairman ROSTENKOWSKI. Mr. Kleczka will inquire.

Mr. KLECZKA. Thank you, Mr. Chairman.

Leon, also welcome to the committee. You can welcome me to the committee, also.

Mr. PANETTA. Congratulations.

Mr. KLECZKA. It was kind of interesting listening to the barge issue. It reminds me of the saying I have used for years and years—and where I got it from I can't recall, but it goes along these lines: Don't cut you. Don't cut me. Cut the man behind the tree. You said that if we keep picking away at this reduction and this particular item, we are going to unravel the whole package.

Let me go back to Ben Cardin's point on the spending cuts. To this day, the President's package still receives a favorable rating by the constituents, at least those who I represent. However, they keep bringing up the fact that someone early on in the administration indicated that for every $1 in tax increases there would be $2 in spending cuts. I haven't found that individual yet. Maybe you can help me out, but nevertheless we don't even achieve a dollar

for dollar. And, of all the criticisms, that is probably the main one, even though in the outyears there is a higher degree of deficit-spending savings, but in the early years it just is not there. In fact, the figures we looked at, Leon, indicate a 70 percent ratio of tax increases versus 30 for spending. The Budget Committee is looking at some increased spending reductions. Can you give this committee a flavor for what they are actually looking at and what your reaction might be to those?

Mr. PANETTA. Well, we have indicated—and the President has said this directly to the Budget Committee. He met with members of the Budget Committee yesterday, a meeting with members today. I have talked with Martin Sabo, the chairman of that committee. And what they are basically working toward is the ability to try to meet the difference between the CBO estimates and the OMB Treasury estimates of where we are. And we think that that is a good target for the committee to work towards.

My understanding is that they are looking at a number of areas to try to reach that goal, but that they are real. They are trying to get within the caps for 1994 and 1995. They are trying to reach the $140 billion in deficit reduction by 1997, and they are trying to reach, I think, the overall number for savings over the 5-year period of close to $500 billion. My sense is that they are working with proposals that will, in fact, achieve those numbers.

Mr. KLECZKA. The President indicated in his address to Congress—and I think it is probably worthwhile for you to repeat it—but, based on his projection of deficit reduction, he indicated—and I often repeat this at home. We are bringing the annual deficit down. However, if we don't address the health care issue in a serious fashion, all that work will be for naught because the deficit will then drive the budget. Could you reiterate some points on that particular problem?

Mr. PANETTA. Yes. I think I have a chart here—I will just hold it up briefly, if you have that chart—which basically portrays it. What you have is a situation where, if you follow the different tracks that we have here—let me just refer to this.

If you look at where the base line is right now at the top, which is the top line, that is where the deficit is headed right now on an annual basis, and you are looking at about $600 billion deficits by the end of this decade. We start to get about $700 billion annual deficits into the early part of the next century. So it is that top line.

The second line is, if you use the economic assumptions that we are using with CBO, which are the conservative assumptions, and implement this proposal—that is the second line. And, as you notice, that starts to go up. A lot of that is due to health care costs. Part of that is just CBO's more conservative economic projections.

The third line is, if you assume the—at least what we think is a good sense of where we think the economy is headed right now with the blue chip and with our own economic advisers—if you assume those, you can see that the line actually drops down even lower in terms of the deficit targets.

If you implement health care reform—and what we have used here is a proposition that basically says we are going to hold health care cost increases to inflation plus increases caused by demographic changes plus 2 percent. If you eventually reach that goal,

that shows you where the deficit line will go. We will reach a point where we can bring the annual deficit to below $80 billion or less, less than 1 percent of GDP, if you implement our proposals and health care reform controls costs.

Mr. KLECZKA. Thank you very much, Mr. Director. I think that points out to all who are here the importance of health care reform for if we don't do that in round 2, after the stimulus and the reconciliation, we have done nothing. So thank you very much for your comments.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Houghton will inquire.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. Director, good to see you again.

Mr. PANETTA. Thank you, Amo, good to see you.

Mr. HOUGHTON. Mr. Director, I applaud what you are doing. I applaud what the President is doing. The President is not a Democrat or a Republican. He is our President, and he is trying to put his hands around something which we have been doing and working on for a long time. The sad thing, I think, and I say this with a tear in my eye, is that many of us who tried to propose and get spending cuts for better economic programs are those who have been left now out in the cold. For a long time those now who are embracing these concepts have really been working against these. However, here we are, and we are all working together.

You say that there are a variety of things which are important to you, and you start with comprehensive elements, fairness, balance, honest, all sorts of things like that. I have a couple that are important to me, and one is the actual numbers of where the cuts and the increases are. I see from page 143 of your budget that, other than defense, there are no spending cuts. The only dent that you put in the deficit via your budget is through defense going down about $40 billion at the end of 1998 and the revenues going up approximately $380 billion. Is that right or wrong?

Mr. PANETTA. If you look at, again, defense plus entitlement savings—and I think you have got to look at entitlement savings as spending savings——

Mr. HOUGHTON. I say that defense goes from $294 to $253 billion, nondefense goes up from $261 to $312 billion, mandatory spending increase from $717 to $928 billion, and then interest, of course, up. So, in effect, the only cuts are in the military when you net it all out.

Mr. PANETTA. Well, again, it is all in the interpretation, but when you take $73 billion out of nondefense discretionary I don't think you can say that that is not——

Mr. HOUGHTON. I am just looking at your numbers here. I may be wrong. I may be reading them wrong.

Mr. PANETTA. Well, if you look—I think the place to look is page 22, which basically lays out the overall——

Mr. HOUGHTON. Could you hold with $143 billion a bit more?

Mr. PANETTA. Sure, but, again, I think if you look at the overall numbers, you have got—defense numbers take, as I say, $112 billion, nondefense, $73 billion. Entitlements are $115 billion. Social Security is $29 billion. You can count that either in or out of spending reductions, depending on how you view that issue. But even if

you take it out, we are looking at about $375 billion there of deficit reduction measures on the spending side.

Mr. HOUGHTON. Mr. Director, I understand that, but at the end of the day in 1998 your deficit is $241.4 billion, is that right?

Mr. PANETTA. In 1998, that is correct, if it starts to go back up.

Mr. HOUGHTON. OK, but when I think I go back to those four basic categories the only cuts when you net it all out are in the defense area.

Let me move on to another issue. I think the thing that is most bothersome to me is not necessarily the deficit, as bad as that is, because you can have $1 trillion deficit in 1 year if you had a very low debt base. But since your debt base is so high, you really worry about it and the servicing of it and particularly if you have any sort of inkling of an increase in inflation.

And, if I read the numbers correctly, the debt now as a percent of the GDP is a little over 50 percent, is about 53 percent. But at the end of the day, of those 5 years, the debt as a percentage of GDP goes up. So I guess the worry I have with all the public excitement and with the great leadership the President is giving is that maybe we are not doing the right things because we don't end up in the right place.

Mr. PANETTA. Amo, if we all struggle around here looking for the ultimate answer, the ultimate answer, then we will never get anything done, and that has been the history here. I have heard Members say, well this is a good program, but it isn't quite what I would have done. And if we always find excuses for why we don't want to support the deficit reduction plan, we will never get the job done. This is obviously——

Mr. HOUGHTON. I am supporting the deficit reduction program. I think it is absolutely right on. I applaud you, and I applaud the President. The only thing is that I don't think we ought to be fooling the American people because what we ought to do is to bend those curves so that at the end of the 5 years we are better off and not worse off, and that is why I talk about the GDP-to-debt ratio.

Mr. PANETTA. Just to answer your question, I think that if we, in fact, implement this plan to put these policies in place, if you then—you have seen what happened in the bond market. If you show that we presented a credible plan, we put it in place, I think, number one, the bond markets are going to continue to respond. Number two, the Fed is going to continue to respond. Number three, as a result of the investment package, particularly on the private sector incentives, that we are going to get more investment that is going to be working in our economy. And the fact is that we have used the most conservative economic estimates about where the economy is going. I think the likelihood is that we are going to see a very good response to this program once we put it in place.

Let me tell you, our European allies right now, when they have met with the Secretary of Treasury, they say you are the ball game right now. You are providing the strongest leadership when it comes to an economic plan in the world. They say they are beginning to hurt, but at least they look to the United States to provide some strong leadership. If we can do this, I think we can put our path in the right direction.

Chairman ROSTENKOWSKI. Mr. Payne will inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Leon, thank you very much for being here, and thank you very much for being the Director of OMB. Having had an opportunity to work with you throughout the last Congress on the Budget Committee, I can't think of anybody who is better suited for this position, and I appreciate the fact that you have taken it on.

I really applaud President Clinton, applaud you and the administration for what I consider to be a very bold, workable visionary economic plan. I plan to support the plan as a whole, and I plan to work with the administration to define and implement some additional spending cuts such as those that you mentioned in your opening statement.

What I would like to inquire about this morning has to do with our committee and has to do with reconciliation. It seems that as we go through the reconciliation we will be doing something that perhaps you have already done, and that is we will be looking at some competing objectives, the objectives of creating economic growth while at the same time reducing our deficit.

I think as this relates to the private sector and as it relates to job creation, we will have to look at the administration's proposals and we will look at proposals such as increasing corporate income tax and how this will be done for businesses that earned over $10 million. We will look at the Btu tax. We will look at investment tax credit on the other side. We will look at capital gains tax reductions for small businesses. And, finally and importantly, we will look at what is going on with interest rates and, in fact, if they will be reduced.

My question, then, is this: Has there been analysis accomplished by OMB or is analysis being accomplished which might look cumulatively at these effects that are anticipated to determine that we will, in fact, be able to create substantial numbers of jobs, I understand as many as eight million jobs? And exactly how does that occur and what is it that we can say to people who seem to be very concerned about their businesses and their ability to participate in this job creation?

Mr. PANETTA. Well, first of all, welcome to the Ways and Means Committee because that is what, obviously, the Ways and Means Committee has the responsibility to do as you work through the reconciliation package in weighing these different recommendations.

Second, I would also urge you to ask Laura Tyson, who is head of the President's Council of Economic Advisers. I understand she is appearing before you. And I think she could give you the economists' view of why we think this is the right policy to put in place.

And, third, I would just say to you that we do believe that this has to be viewed as a comprehensive proposal if you put in place the stimulus package which we think is an insurance policy with regard to where the economy is going right now. We think that, while there are some good signs, we are concerned that you have got to keep some jobs moving and put some jobs into the economy. That is one.

Two, the investment package. The President feels very strongly that this country does need to make some very targeted invest-

ments again, that we have got to make these investments in infrastructure so we have a first-class transportation system in this country. We have got to make investments with regard to education and to the kind of lifelong learning needs of our people.

When I was chairman of the Budget Committee—you were there—CEOs came before the Budget Committee and said, you have got to fully fund Head Start. We want you to fully fund Head Start. We want you to fund the WIC program. Because these are investments in the quality of people that we ultimately use in our corporations and in our businesses. We have got to have a skilled work force.

The President believes you have got to make those investments. You have got to make investments with regard to health care. You have got to make investments with regard to technology and R&D. And you have got to provide these tax incentives. Then you do the deficit reduction.

Now, clearly, this is—we are walking a tight balance here. As you build in your stimulus and your investment package and your deficit reduction comes in, the argument is that deficit reduction does have some negative short-term impact. We talk budgets. You know, budgets, numbers represent people and impacts on people, so there is going to be some negative impact as you go through that.

But the combination of these policies, working at the same time, are going to produce a sense of confidence in this country that we are on the right track. They are having an impact on interest rates. They will have an impact on the level of investment. Most importantly, though, they will have an impact on the level of confidence the American people have about the future.

The worst thing I see right now is people worried about whether their kids are going to have a better life in this country. That is the worst problem we have in the United States right now is people who are worried about their kids. I worry about my three sons. Are they going to have a better life? My father and mother who came to this country as immigrants, I mean, their dream, what they worked for every day of their lives, was that they wanted to have their kids have a better life. That is what the American dream is about, and we are seeing that American dream evaporate.

So the key here is to try to provide change and a sense of confidence to the American people that our kids are indeed going to have a better life in the future. I think this plan does that.

Mr. PAYNE. Thank you, Mr. Director.

Chairman ROSTENKOWSKI. Mr. Hoagland will inquire.

Mr. HOAGLAND. Well, thank you, Mr. Chairman.

Leon, I also want to commend your leadership and your energy and your commitment that you have brought to this effort. There is really nobody better in the work that we have done in the last four years together on the Floor. You are an authentic deficit hawk—I think we understand that—and you are in a great spot right now for the good of the country.

Sandy Levin talked about his lively constituent meetings, and I had one Sunday. And I would like to talk to you about one proposal, one area, where we might be able to achieve some additional savings. The proposed investment tax credit that is described in "A

Vision of Change for America" is basically divided into two pieces. First, there is a small business investment tax credit which would be available for businesses with an average annual gross receipt of less than $5 million.

I would like to focus on a second piece, Leon, the so-called incremental investment tax credit. Now, that incremental credit would be available to businesses with gross revenues in excess of $5 million. It would be a temporary credit covering property placed in service on or before December 31, 1994. Taxpayers would be eligible to claim an incremental credit in excess of their investment in property over a fixed base.

Now, the Treasury report notes that it would promote the purchases of new equipment and thereby promote capital investment, modernization and more rapid economic recovery in the short run. These, of course, are laudable goals. The problem is that it will only produce a more rapid recovery if, in fact, the businesses taking advantage of it are acquiring equipment that they would not have but for the availability of the credit.

Now, I am being advised by a number of CFOs and CEOs of sizable companies in Nebraska, including Fortune 500 companies, that the availability of the incremental credit would not actually impact their investment decisions, that they would be more than willing to accept the tax benefits of it but that it would not change their conduct, and, clearly, we don't want to reward conduct that would have occurred anyway.

And I just wonder, given the fact that the recent studies have broken out the revenue loss from this particular tax credit proposal, the incremental tax credit proposal, as between $9 million and $12 million—I guess what I am asking you to do is to defend that proposal. Is it worth the $9 to $12 million or perhaps more that it is going to cost the Treasury over the next four to five years? Is there really solid evidence that it is going to affect business decisions out there?

Mr. PANETTA. Obviously this is something we need to continue to analyze and make sure that we are making the best possible recommendation.

We think this does make sense. The reason we think that the incremental tax credit makes sense is because what is needed here is that kind of jolt to try to push people along, to try to make those investments that should be made now, knowing that they are going to have benefits of this tax credit.

The key here is that in our talking to people at—in various chambers of commerce, the business community that we have talked to, we have talked to both mayors and Governors as well as a lot of small business people throughout the country, the sense is that this is going to help. It is not going to—they want to be able to start some investment. This is part of the answer, part of the answer.

The other part of the answer is trying to get the credit crunch loosened up in this country so that, in fact, banks are going to be willing to make those loans. And the President will be announcing a package to try to make sure that we loosen up on the credit crunch as well. Combine that with what we are doing, obviously, on deficit reduction in the long run, combined with some of these

other tax incentives. We think that the package represents the kind of incentives that are going to help business try to pull out of this recession.

So I am well aware of the concerns about, you know, will this in and of itself, determine investment decisions. That is questionable. But if it is combined with the rest of this package in terms of the other tax incentives that are part of it, combined with what we are doing on deficit reduction, combined with what the ultimate impact I think will be on interest rates, combined with what we want to do on the credit crunch, then I think the answer is that this package can, in fact, provide the stimulus we need.

Mr. HOAGLAND. But, Leon, if we are not satisfied that this expenditure of $9 to $12 million in tax expenditures, in revenue loss, you know, will affect all our behavior, then it would be better not to put it in the package, wouldn't it?

Mr. PANETTA. Again, I guess what I would urge you to do, Peter—you have to look at the overall package. If you isolate any one of these pieces in and of itself, if you say, look, if we just do the extender on tax credit for R&D by itself, is that going to produce a lot more R&D in the country? Who knows? Maybe yes. Maybe no.

But when you combine the extender in the R&D, combined with the other extenders, combined with this, combined with what we are doing on targeted capital gains as well as some of the other pieces, then I think the answer becomes yes. So that is what I would urge you to do. I know that you are concerned about that.

Chairman ROSTENKOWSKI. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

I would like to address the Congressman from Nebraska's comment about the investment tax credits. There is a factor that a lot of us don't consider when we talk strictly about the businessman making a decision on whether he should expand his business based on the investment tax credit. You also have to consider the jobs created by the companies that supply him with equipment. If he doesn't postpone ordering, you do generate economic activity from those supplying organizations that fill the orders. So it is a much bigger picture. You can't just look at one factor.

I happen to be a businessman. I happen to have been involved a little bit in selling equipment that qualifies under the investment tax credit. And, quite frankly, it does generate economic activity. So there is more to it than just the first orders that you look at.

I have a little cold as you can tell.

One of the things that came out of the meeting we had last Wednesday with the President was a little item called line item veto. The President made the comment that, as Governor of Arkansas, he exercised the line item veto 20 times. As a result of doing that, it seemed that the State legislature, the parallel of the U.S. Congress, learned its lesson and quit sending stuff to him which would be line item vetoed.

He asked and said during the campaign he would like to have a line item veto. I noticed in his State of the Union Message he did not ask for it. However, he did say to this group that if you send me a line item veto, I will sign it.

I think the Republicans are willing at least 170-some odd of us are willing to vote for a line item veto for Bill Clinton. Can you get us enough Democrats to do the job?

Mr. PANETTA. Well, we had a very strong vote on this issue in the last Congress. I think it was an overwhelming vote of both Republicans and Democrats supporting the so-called enhanced rescission approach to line item veto. And as a matter of fact, this Wednesday I am going to be testifying before the Government Operations Committee here in the House in support of that proposal. So I hope that Congress does move that legislation, both the House and the Senate.

The Senate—we understand there are some additional problems. But we think that it is important to start that ball rolling in the House side. And, as the President indicated to you, he will support that effort, and he will sign that bill.

Mr. HANCOCK. I wasn't enthused about enhanced rescission. I think it ought to be line item veto. I think it ought to be short, sweet, simple and give him the authority. I think this is a tool of management. It is a tool that anybody has to have before they can control the budget.

Let me ask a question. During the campaign a statement was made having to do with the Social Security earnings limit. The President was in favor of getting rid of the earnings limit on Social Security for people 65 to 70. Maybe I am interested in it because I am 63 years old, but, there is nothing in your proposal that even mentions it. Has there been any consideration given to that?

Mr. PANETTA. We have not specifically discussed the issue of earnings limitations. Obviously, if it were to happen, we would want it to be done on a pay-go basis so that we don't lose a lot of revenues as a result of doing that. That would have an impact on the Social Security trust fund and, for that matter, on our deficit reduction efforts.

But I think—in terms of substance, I think the President shares some of the same concerns you do, and he reflected those during the campaign. But if we take any action on that it ought to be paid for.

Mr. HANCOCK. One final question. How do I go about explaining to senior citizens that an increase in the tax on Social Security from 50 percent to 85 percent would be scored as a cut in spending?

Mr. PANETTA. Under the scoring proposals that we have used during Republican administrations and Democratic administrations, but particularly even in the last budget agreement, normally, when you reduce benefits that are entitlement benefits—for example, if you shave COLAs or take anything off the benefit side, it is viewed as a spending savings.

For example, one of the arguments we get on fees is why should fees be considered a spending savings. Fees are considered a spending savings because it reduces spending on the part of the Federal Government. You take in fees. It reduces the spending you have to do in various areas. In this instance, it is viewed as a benefit reduction, and, therefore, has been counted in the past as a spending savings.

I don't want to—I have kind of taken the approach that, look, you don't have to put it in that category. If you want, you can categorize it as a revenue increase. But I think the bottom line is that we need to get it done in order to complete the deficit reduction package.

Mr. HANCOCK. Thank you very much.

Chairman ROSTENKOWSKI. Mr. McNulty will inquire. Mr. McNulty?

Mr. Reynolds will inquire.

Mr. REYNOLDS. Thank you, Mr. Chairman.

It is good to see you again, Mr. Panetta. Congratulations. Thank you so much for coming today and sharing with us some of the President's ideas on the deficit reduction program and our economic growth program.

As you know, I am particularly concerned about the costs in our economy that guns cause. Last year in Chicago 40 people were shot every day and 2 of them died. That was an enormous cost on the health providers because most of these folks—a lot of these folks weren't insured. I am going to introduce legislation which would effectively double the excise tax on guns. If that legislation had been in place or if the law had been in place last year, that would have been an additional $80 million which could go into a trust fund that would go to hospitals to help defray the cost of caring for uninsured gunshot victims.

I have heard a lot of talk about the possibility, and my question is, can you comment on whether or not the reports that we read that the President is seriously considering such a tax be included in the stimulus program?

Mr. PANETTA. This would be a tax, again, on what?

Mr. REYNOLDS. On guns. An excise tax on guns.

Mr. PANETTA. We discussed a lot of issues and a lot of approaches to this. I have to tell you that, at least as far as I know—and you should ask, I believe, Secretary Bentsen the question, at Treasury—but as far as I know that is an issue that is not being considered at this point. I think, as the President would say, obviously, if the committees decide that they want to move some proposals along those lines, we would be happy to try to work with you on that. The key is that you want to be able to try to insure that whatever proposals you put in we protect a coalition of votes to try to get the overall package through.

Mr. REYNOLDS. I understand that. It appears that from an article in this week's Newsweek that the President is, in fact, somewhat—and the administration is considering this.

Mr. PANETTA. What I am finding out is that it is a big administration.

Mr. REYNOLDS. I will bet you are. I hope to work with you further on this issue and look forward to doing just that.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jefferson will inquire.

Mr. JEFFERSON. Mr. Panetta, let me ask you, I know a great emphasis in this program is to create jobs through targeted provisions in the tax laws, in the capital gains provisions and in the investment tax credit provisions. I want to ask about the capital gains provision if I might.

I would like to have you try and quantify how you see these provisions playing out to create jobs in the inner-city areas. I know there is an enterprise zone provision, but, as I appreciated it, it is kind of a long-term idea. And it can only really work if a company is sitting in one of these areas that we are trying to target and it is profitable and, therefore, can take advantage of the income tax credits that would be permitted.

The real problem is a gap in capital. If you look at the 1990 interim report of the Minority Business Development Authority, it states there that the real need is availability of capital and that really what we are talking about here is not so much debt-financed capital but venture capital as well. And so I want to know whether you will drive venture capital to the minority business community because history teaches that these minority businesses hire African-Americans, Hispanics, Asians, minorities that are in these communities. They hire them quite well. And so if you are going to get at employing minorities, we have to get at closing the capital gap that affects minority businesses. So is there anything here that deals with that aspect of it? Tell me in a few years how it plays out.

Mr. PANETTA. Well, you have raised a legitimate concern which is that sometimes the credits that apply to some businesses in other areas, when you look at the inner city, is that something that they can benefit from? We think that, ultimately—obviously, if we can implement an enterprise zone approach here that tries to focus some of the targeted tax incentives to those enterprise zones that there can be a benefit. That is a little long range, I admit that.

I think in the short term, the combination of what you have in the stimulus package plus some of the investment pieces are probably the best directed efforts that you can have with regard to the inner city.

For example, we put a large investment in CDBGs. My experience with community development block grants is that those are the most effective at being targeted at projects ready to go and at the communities that need them the most, and they come with a minimum of strings attached to them. And I think they are the kind of direct investments that would help particularly in inner cities. We combine that with the Economic Development Administration, which is also very effective.

I have to tell you my own experience in a community that was hit by a base closure is that the two best things going for that community are CDBGs and EDA because they are able to send money directly into that community to try to assist with economic redevelopment.

In addition to that, obviously, we have the targeted programs with regard to jobs, job training, as well as these investment tax credits which even if a company goes into that area and decides they do want to invest more in terms of equipment or building investment, that will help them as well. So it is really that combination of programs that I think is much more beneficial to the inner city businessmen than if you just pick out one of these tax incentives.

Mr. JEFFERSON. I appreciate your response, and I agree with what you have said. But I want to ask you this, if you would be

open to our talking about a program that might lure venture capital into minority communities. I am thinking of a capital gains exclusion of 50 percent with a 3- or 4-year holding period targeted to minority businesses. It might be a good way to draw venture capital in if we use that vehicle. If investment were to take place, the preference would operate in the same way as a magnet to draw the venture capital in. That is a real need.

Mr. PANETTA. I think that is worth looking at.

Mr. JEFFERSON. I would like to talk to you about that further. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Archer for a unanimous consent request.

Mr. ARCHER. Thank you, Mr. Chairman.

I had an opening statement which it would be inappropriate for me to read at this time. I ask unanimous consent that it be placed in the record at the beginning of these proceedings.

Chairman ROSTENKOWSKI. Without objection, it is so ordered.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Over here, Mr. Panetta. Welcome to the Ways and Means Committee.

Mr. Panetta, you have heard it said, I am sure, that the reformed smokers are probably the worst about tolerating smoke. Well, you are looking at a reformed summit supporter. You will recall I supported the summit in 1990 and gritted my teeth and swallowed what we had before us. But as a reformed summit supporter I can tell you that I am not going to support this package, and I am not going to support any package that does not have, (a), more spending cuts than tax increases, and, (b), those spending cuts up front and not backloaded. I don't think this program passes either test.

I have got to say that serving with you on the Budget Committee was a very good experience. I admired the way you handled that committee. I thought you were straightforward and honest with the committee, and, really, I respected your handling of our committee. I expect you to perform the same way as Director of the OMB, and I am looking forward to that.

But in your early statements on this whole matter of getting the deficit under control—and, in fact, I think you were speaking before the Senate just about a month ago or so—you said that the plan you were going to come up with was going to have $2 of spending decreases for every $1 of tax increases. What happened? Frankly, even as a summit supporter reformed, I could have gritted my teeth one more time and supported something of that sort. What happened to that?

Mr. PANETTA. Let me ask you, do you support a freeze on COLAs?

Mr. MCCRERY. Mr. Panetta, you know from 1990 that I am willing to support a lot of stuff that I don't want to support if it is going to get this country in better shape. But you said—you yourself said—and I have said you are an honest guy and I like you—that your sum was $2 of spending cuts for every $1 of tax increases. I am just asking you what happened to that plan that I might have supported?

Mr. PANETTA. The answer to the question is there are a lot of Members who, when it comes down to dealing with spending cuts, have serious problems, particularly when it comes to retirement programs and dealing with the whole issue of what we do with cost-of-living increases. And that was a concern on the Senate side. It was a concern on the House side as well. And, for that reason, the President felt that it was very difficult to put that into a package and have it blow up and undercut the package to begin with.

We started as always, using a target of two to one, because I think it is an important place to start. Ultimately, this package gets us there. Sure, taxes, when you put taxes in place, they go into effect more immediately. The spending cuts, as you know from the defense budget, you don't get those dollars in the first year. You don't even get them in the second year. It takes 3 to 4 years to get the dollars out of the defense budget.

The same thing is true with regard to entitlement savings and Medicare savings. You don't get those dollars immediately. Those dollars flow in 3 and 4 years down the road. When you look at the bottom line at the end of the road, we are achieving more in spending reductions than we are in revenues, almost 60–40 in 1997, so we do move in the right direction. And so I guess I would just urge you, when you are looking at a comprehensive plan like this, you not look just at the first year.

And that is true for the budget agreement. You supported the budget agreement. You didn't get an immediate return in the first year. It took a while to develop the $100 billion in savings that——

Mr. MCCRERY. We don't want to talk about the effect that summit agreement had on the economy, I don't think.

Mr. PANETTA. Don't walk away from that too fast.

Mr. MCCRERY. We don't want to talk about the deficit reduction that was achieved from that summit. So don't get us into that.

Now if you look at your current proposal and you remove the Social Security increase, which both CBO and the Joint Tax Committee have said should be scored as a tax increase, and if you reclassify the earned income tax credit that—again, CBO has said it should be scored as a spending reduction increase—what is your ratio now in this package of tax increases to spending cuts?

Mr. PANETTA. Well, I think that the numbers that we have on page 22 are still the numbers we are working with. It looks like the Budget Committees on both sides will probably be adding to the spending cuts, particularly in the early years, 1994 and 1995, so that it will probably be more—I don't know—I would imagine maybe even dollar for dollar in 1994 and 1995. If that is true, by the time we get to the overall package, you may very well approach a 2-to-1 number with regard to spending reductions versus revenues.

Mr. MCCRERY. You didn't accept the premise. I appreciate that. But when you reclassify properly the Social Security tax and the earned income tax credit as CBO and Joint Tax do then you get numbers like $290 billion of tax increases over 5 years and only about $100 billion of spending reductions.

Mr. PANETTA. In the final analysis, no matter how you score Social Security—no matter how you score Social Security, however

you want to do it, the bottom line is that there are more spending cuts than tax increases by 1998. No matter how you do it.

Mr. McCRERY. Over a 5-year period, though, no, sir. Perhaps in the last year you can get that, but over the full 5-year program——

Mr. PANETTA. If you look at the whole package——

Mr. McCRERY. I am looking at the whole package. I am looking at the 5-year effect. It is nearly——

Mr. PICKLE [presiding]. The time of the gentleman has expired. Mr. Coyne will be recognized.

Mr. COYNE. Thank you, Mr. Chairman.

Welcome, Director Panetta. I want to commend you on a very effective and comprehensive and direct and honest statement about where we are relative to the President's package and relative to what effect that is going to have on the deficit situation. You and the President are to be commended for giving accurate figures and forthright figures, and that is a welcome change here in Washington.

My question has to do with the North American Free Trade Agreement and the possibility that we here in Congress and the President might adopt a North American Free Trade Agreement and what provision has been made or will be made for those people who may find themselves dislocated as a result of the implementation of a NAFTA agreement.

Mr. PANETTA. We are—obviously, the President is very concerned that we include sufficient funds in here to deal with at least the short-term impact of an agreement like that, particularly with regard to dislocated workers. There is a significant amount that we have built in here. We are looking at almost $2 billion by 1997 on dislocated workers. I think it is about five overall—five to six overall.

We also tried to target help with regard to job training programs. We have significant targeted increases in job training, and we also try to improve job placement provisions.

Secretary Reich right now is working on a proposal for dislocated workers because we are concerned not only about the impacts of the NAFTA agreement but also, if we implement these base closure proposals we have inherited from prior policies, we are going to have some additional dislocated workers as a result of that. I think what we are going to find is that that program is going to be very key to trying to make this transition both with regard to the NAFTA agreement as well as some of the reductions that are part of the proposal.

Mr. COYNE. On another subject, since the President has made his proposal to the Nation there has been speculation that inasmuch as the economic projections and the forecasts and the results of the markets have been very positive and we are getting some positive economic news since the President has made his proposal that maybe we ought to delay or do away with the economic stimulus.

The question I have is, how important is it to have the economic stimulus package to make the budget figures work?

Mr. PANETTA. The President thinks that it is extremely important that we continue to focus on the need for a stimulus package in this country. We have gotten some encouraging growth numbers. We have gotten some encouraging unemployment numbers this

past week. But the fundamental problems in the economy are still there. We are still seeing contractions in businesses and corporations. They are still laying off people almost every week. We are going to see continuing contractions with regard to defense closures.

I used to represent a community that was hit by base closure. The decision on a base closure was 2 years ago. This is the first year the troops are moving, and so we are having the impact this year. And other communities are going through the same thing. When this list comes out within the next few weeks on additional base closures, you better believe that there are going to be some contractions that take place as a result of that.

In addition to that, you are looking at continuing unemployment numbers that are high. We are still looking at a credit crunch in our economy. So the fundamental question everybody has got to ask is, are you willing to take a risk with the present economy? Are you willing to take a risk by doing nothing? The President thinks that the message that came out of the November election was, don't take a risk. Try to take some action to ensure that this recovery keeps going. This stimulus package is extremely important right now.

Mr. COYNE. So not only is it important to put people back to work it is important for the economy as a whole.

Mr. PANETTA. I think it provides the kind of investment, short-term investment in the economy that will get this recovery going and provide the kind of cushion we need when we get into heavy deficit reduction.

Mr. COYNE. Thank you very much.

Mr. PICKLE. The Chair recognizes Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman.

Leon, I don't guess it would be appropriate to ask if the base closure had anything to do with your move over to OMB, but it is certainly a pleasure to have you with us today. And I think the ultimate commendation for what you and the President are doing addressing the deficit, comes from the fact that the markets have reacted as positively as they have, both the stock market and bond market. It is obvious investors believe that you are serious and that you are going to do something to correct the Nation's deficit.

I did eight town meetings during the recent work period in February. At those town meetings our constituents made it clear that they are ready for change. They are ready to pay some additional taxes. They are ready for some serious cuts. Most said they would like to see additional cuts to what were in the package. All said they thought it was important that the taxes raised go to reduce the deficit.

As you are aware, there is a group of us who put together a program that would require the taxes raised must go into a trust that can only be used to reduce the deficit and that any new spending cuts have to come from cuts in existing programs. I would certainly encourage the administration to look at that closely because the public certainly accepts and supports that.

Another thing that I think is very important is on the energy tax, the Btu tax. Whatever we do, however it is structured, it must be collectible, and it must be fair. From many standpoints I would

hope that you looked at the collectibility side of it as being very important, especially on natural gas, oil, and electricity.

From the fairness standpoint, I would hope that you would look at the problems concerning the collection on oil or refined products. As you are aware, the number of Btu's in a barrel of oil are roughly twice that as in a barrel of gasoline, so if we are not careful in the way this is structured we will eliminate refining jobs in the United States and have refined products coming in here from all over the world because the tax would be roughly half that of gasoline refined in the United States. I would hope you would look at that.

Another thing, cost containment on health care. If we bring 35 million people into the system and we have no cost containment, whatever we do on the deficit is for naught. I think it is extremely important that we develop cost containment procedures all the way through, and I think that we must do that if we are to control health care costs.

The second part that really kind of struck me as unusual, why in the world don't we have any providers, any people who have been in the health care field as actual providers on the health care task force?

Mr. PANETTA. Okay, what you have is a situation where people who actually serve on the task force itself have got to complete all of the ethics forms, et cetera, in order to be part of that kind of actual working group. But I can assure you that the task force itself is, in fact, working with the AMA, working with the providers, working with the hospital people, working with all of those who service the health care industry in this country. And they are, in fact, very active advisers with regard to the various proposals that we are dealing with.

So I think—the President I think would assure you and I think assure the rest of the country that while, for whatever ethics purposes, they can't sometimes be in the actual room where the drafting is going on, they are very much a part of the advisory groups who are working on the proposal.

Mr. ANDREWS. Would the gentleman from Oklahoma yield?

Mr. BREWSTER. Sure.

Mr. ANDREWS. The President told a group of us yesterday that there are over 60 doctors on the task force. I am not sure how many hospital administrators, if any, are represented, but over 60 doctors, according to the President, are on the task force.

Mr. BREWSTER. That is interesting. I was told that there were no providers, doctors, pharmacists. As one who has been in health care most of my adult life, it was interesting to me that we had no one who had been an active provider. There may be some academic-type physicians, but it was my understanding there were none who had actually been out in the field.

As one who has been in the field in a lot of different things with health care, I think the people in the field can assure you a lot of cost containment that someone else may not understand how to get.

Mr. PANETTA. You are absolutely right.

Mr. BREWSTER. Cost containment is extremely important to what we do here.

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Mr. PANETTA. I want to assure you that the providers will not only be providing important guidance but we look to them as we develop this package in the health care task force.

Mr. BREWSTER. Thank you very much.

Mr. PICKLE. Mr. Thomas will inquire.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. Panetta, it is different seeing you on the other side of the table.

Mr. PANETTA. It feels different.

Mr. THOMAS. What is the old song about walking a mile in another man's shoes? I remember for years sitting near you on the Budget Committee in which administration principals, including Directors of the Office of Management and Budget, would present numbers. You would ask where the numbers came from, and you would counter with numbers from the Congressional Budget Office, CBO.

In fact, during the State of the Union, as I recall, one of the highlights on your side of the aisle may have been when the President urged a single set of numbers. There was applause on both sides of the aisle with that remark. Then I believe he ad-libbed when talking about the fact that the CBO numbers historically had been more conservative, that is, more accurate than OMB. There was loud standing applause on your side of the aisle for that ad lib.

As mentioned earlier by the gentleman from Louisiana, when you look at the budget there are some anomalies that those of us who are a little more familiar with the way in which "scoring" is done who need to have a better understanding.

On Social Security benefits, the idea that a larger portion of the benefits for those individuals above certain incomes would be subject to tax, is considered a spending cut by the Office of Management and Budget. Congressional Budget Office and the Joint Tax Committee scored it as a tax increase. Whose scoring is right? Is it a spending cut or is it a tax increase? Do we go with the OMB approach or do we go with the CBO approach?

Mr. PANETTA. Bill, I wouldn't get too wrapped up in it. Whatever you want to call it, you call it. Just enact it for the purposes of deficit reduction.

Mr. THOMAS. What do you call it?

Mr. PANETTA. Under the scoring that we have traditionally used——

Mr. THOMAS. Who is "we," OMB or CBO?

Mr. PANETTA. OMB. And we have had—look, even Senator Packwood, when he was at a press conference, indicated that scoring, generally, when you nick away at Social Security is considered as a spending reduction. So it is not just a Democratic viewpoint. This is generally the scoring that is going on on both sides of the aisle.

Mr. THOMAS. Let me try it once more. I asked a question, and if you don't want to answer it, then I understand that. Your answer a year ago would have been fairly clear and emphatic, and I understand why perhaps it isn't now. Do you go with the CBO scoring as a tax increase or the OMB scoring as a spending cut?

Mr. PANETTA. What we have presented it as, in our scoring, in a spending reduction, but if you want to—if you want to go with CBO, you go with CBO.

Mr. THOMAS. CBO says it is a tax increase. You choose not to use CBO scoring. On earned income tax credit, OMB counts it as a tax cut. OMB is now saying it is 90 percent or more a spending increase. So I assume, since you are going with the OMB analysis rather than the CBO, I do want you to appreciate how those nails in the bottom of the shoe push up when you do change jobs. A year ago you would have been emphatically defending and supporting the Congressional Budget Office scoring, and I am inclined to go along with them.

Last comment. The gentleman from Oklahoma, Mr. Brewster, implored you to look at the way in which the Btu tax is implemented. I can assure you I have enormous concerns as well since my small Congressional district in California, one of 52 in California, produces more oil than the entire State of Oklahoma and all of its representatives.

The irony of the Btu tax applied to oil, as you know—and if you don't I am going to tell you—is in terms of a low specific gravity oil, a heavy oil versus a high specific lighter or a higher quality oil. The heavy oil is cheaper. It is not as good. The light oil is more expensive. It is "better". But the heavy oil, the low specific gravity oil, generates more Btu's. So under any kind of a tax scheme that deals with Btu's, you are punishing a cheaper product versus a higher product.

We got into this with the windfall profit tax in terms of burning oil in situ versus shipping it off of the property. If you ship it off the property it was taxed. If it was burned on site it wasn't. So you had higher pollutants being generated by burning crude oil instead of bunker fuel.

I hope we don't go down that road again in which a Btu tax is applied and punishes heavy oil when, in fact, it is a lower cost product.

Mr. PICKLE. The time of the gentleman has expired.

Mr. PANETTA. If I could just respond, Jake.

Mr. PICKLE. The time of the gentleman has expired. Did you wish to say anything additional?

Mr. PANETTA. I thought I would like to respond.

Mr. PICKLE. All right.

The Chair recognizes Mr. McDermott.

The Chair recognizes Mr. Neal.

Mr. THOMAS. Welcome to the other side of the table.

Mr. PANETTA. Could you yield to me 10 seconds?

Mr. PICKLE. Mr. Panetta, did you wish to respond?

Mr. PANETTA. I would just want to make a brief comment on that.

The Btu tax, the formula on that, is extremely important. We are continuing to work with approaches on that formula. What you have pointed out is important. We don't want to penalize those that are energy efficient.

Mr. PICKLE. Now, Mr. Neal.

Mr. NEAL. Thank you very much, Mr. Chairman.

Let me welcome Mr. Panetta here as well. I think that your budget-cutting credentials are impeccable in this institution, and everybody has great respect for the work you have done and the courage you have demonstrated over the years here.

Let me ask you specifically about two big items, the supercollider and the space station.

Mr. PANETTA. Oh, yes, I remember those.

Mr. NEAL. Where are you headed on those? We will just keep it among us in the room.

Mr. PANETTA. Let me tell you exactly where we are with regard to the policies in those areas.

With regard to the space station, we obviously presented a number of proposals to the President. The President is committed to the space station or the mission of a space station. He does, however, share real concerns with the Office of Management and Budget and I think many Members who are concerned about the cost overruns that have taken place in that project. We are looking at about $500 million. It may approach almost a billion in cost overruns.

As a result of that, the President made the decision that the project needs to be redesigned in order to ensure that we implement a cost-effective approach to that mission. So the proposals we presented in the budget include savings that would flow from a redesign of the space station mission. And right now NASA is working toward that kind of redesign. We think in the end that this will not only ensure a space station, it will ensure against cost overruns and, more importantly, it will protect and enhance the other missions at NASA because, if we kept on the track we were on, the likelihood is that 20 other missions at NASA would be wiped out. We did not want that to happen.

On the super conducting supercollider, again, the President thinks that is excellent science and that is something that we do need to continue to invest in because you want to stay on the cutting edge of where science is going for the future. There are some concerns, again, about cost overruns. There are concerns about some of the technology. And so, for that reason, what we have done is basically stretched that out. We get some savings, but we are committed to the project.

Mr. NEAL. All right.

Secondly, I voted for the budget accord in 1991. And, at that time, we talked about interest rates that were beginning to demonstrate some stability and indeed were headed down. Today I don't think anybody would have assumed that interest rates would be where they currently are. What do interest rates do to projections currently on the budget deficit? And can you safely say that the worst of the S&L crisis is behind us? And what does that do to the projections of the deficit?

Mr. PANETTA. Obviously, any time interest rates start to come down, it is extremely helpful in terms of the stimulus, as I have indicated, that flows into the economy. The fact that people now, just based on the reduction in long-term rates, are beginning to refinance their homes. They are reducing their mortgage payments.

I talked to the mayor of Houston when I was down in Houston recently. The mayor said as a result of being able to refinance some of the loans in the city they are able to save almost $30 to $40 million in just finance costs alone. I mean, that is significant. That is going on right now so it provides a tremendous impetus.

As a matter of fact, our hope is, if we stay on this track, you are going to see these projections turn much more optimistic in terms

of our ability to reduce the deficit because it clearly is going to flow into additional revenues as well as, I think, additional investments for the country.

On the issue of the RTC, we had built in about $34 billion into the baseline for the budget on the RTC. We think that that may be adequate, although Treasury is taking another look at that issue. But we think that we have turned the corner, hopefully, with regard to the whole Revenue Trust Corporation and the S&L crisis and that things are beginning to go in the best direction right now.

Mr. NEAL. Just a footnote. Hang tough on the stimulus package. I think it is necessary beyond those who would have us believe that it is simply make work. The highways, roadways, bridges, airports, and railroads of the Nation are falling apart. It is a sound investment over the long term. And for the most productivity, giving greater gains and indeed is an investment. I hope you stick by your guns.

Mr. PICKLE. Mr. Chairman, is it the intention of the administration to recommend acting on some of these specific programs that Mr. Neal just mentioned here?

Mr. PANETTA. You mean with regard to space station and——

Mr. PICKLE. For instance RTC—are you going to recommend action in the RTC area?

Mr. PANETTA. Yes, we are. We will ultimately have a recommendation to the Congress on that issue.

Mr. PICKLE. Thank you.

The Chair now recognizes Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Panetta, I am a representative from this committee on the Budget Committee. And over the past 2 weeks I have been hearing a great deal of conversation about having a deficit reduction trust fund. And it has been my experience in thinking of this, because this is not exactly a new idea, that it would be probably very difficult to administer and maybe difficult to make feasible. However, this conversation has continued at the Budget Committee. I know there is going to be some language about it in the budget resolution. I wondered if you could comment with your vast experience as Budget chairman and now in your position today what you think about a deficit reduction trust fund.

Mr. PANETTA. Well, I have, as chairman of the Budget Committee and as a Member of the House, looked at various ideas for establishing this kind of fund. Does it make sense? Are you, in fact, setting it aside for deficit reduction? Is it fungible in the sense of trying to deal with other needs? What happens if you have a crisis? What happens if you need to use those funds? There are a number of aspects with this that have to be considered.

I understand the need to say to the American people that, if, in fact, we are going to provide these additional taxes or spending cuts, this is going for deficit reduction. And so, to that extent, we are trying to work with the people who have developed this idea.

But I have to tell you that it is not an easy one to put into place. You have got to be careful you don't tie our hands so that we are unable to respond to needs that we have to confront at the Federal level. But I think there is at least a way perhaps to assure the public that we are trying to establish some kind of funds so that they

can look at that and know that, in fact, there are funds that are going for that purpose. I just think we need to protect our flexibility, and that is something we are looking at right now.

Mrs. KENNELLY. Thank you.

The other day, when we were in the Budget Committee, I mentioned to you that we were obviously all looking very, very hard for any way we could increase deficit reduction. I asked you about the Department of Defense, their health savings, because they used the methodology of Medicare. I was wondering, has it been decided yet if we can use those savings from DOD for deficit reduction in this budget package?

Mr. PANETTA. We have taken an initial look at it, and it doesn't look like those are scoreable savings. But let me get back to you with regard to our specific findings on that. I will let you know.

[The following was subsequently received:]

The Defense budget has made a substantial contribution to deficit reduction, $6.8 billion in 1994 and $77 billion during FY 1994 through FY 1997. A portion of these outlay savings, $68 million in FY 1994 and $1.4 billion between FY 1994 and FY 1997, reflects cost containment efforts in the DOD health program.

Mrs. KENNELLY. Thank you very much, Mr. Panetta.

Mr. PICKLE. The Chair recognizes Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman, and let me congratulate you, Leon, in your new position. I think the President is to be complimented for having picked you for the job he has. I think you have an understanding of some of the complexities of this process infinitely better than your predecessor.

You made a reference here to the legacy we inherit, and you mentioned the fact that job creation does not occur coming out of the trough of the recession we have just been through. And yet GDP has increased. The report this morning indicates productivity is at its highest level per worker in this country in the past 20 years. In that context, when you talk about job creation and a billion dollar investment in creating a half a million summer jobs, have you gotten into the specifics of how that money is going to be targeted for expenditure?

I say that because in make-work summer jobs like that, historically, those kids haven't learned a thing. Studies have shown that the kids coming out of that kind of artificial employment, if you will, earn less when they take bona fide jobs than the kids who were never beneficiaries of those make-work programs. What exactly do you have in mind in the way of training?

Mr. PANETTA. Well, the basic focus of the stimulus package is in three or four areas. The first is about a $3 billion amount for highways because we think that the biggest immediate return you can have is to get those highways and repair projects and maintenance projects going early. Those are permanent jobs. We can break the ground, and we have made a commitment to fully fund the highway bill that was passed by the House and Senate, signed by the President. So the biggest piece here is $3 billion for highways. We think that can be obligated and we can actually get bids on within the next, hopefully, 90 days.

The second piece——

Mr. CRANE. Wait. Before you proceed further, are you saying that you are going to train these kids to take highway jobs?

Mr. PANETTA. No. No. This is a separate package going right to the—this goes right to highway projects. In other words, it is part of the highway trust fund expenditure. It is to try to implement projects that both the States and the local communities already have with regard to——

Mr. CRANE. That is divorced from the $1 billion you are allocating for the summer youth program?

Mr. PANETTA. That is aside from the $1 billion.

Mr. CRANE. That $1 billion is what I am concerned about. What are you going to have those kids do?

Mr. PANETTA. Well, again, the main part is in highways. We are doing CDBG with regard to public works development. We are doing some with regard to waste water development. There is the $1 billion for summer youth, and, obviously, the summer youth programs are basically targeted to try to get kids off the streets to put them——

Mr. CRANE. How many hours a day for a paycheck?

Mr. PANETTA. What we are trying to do, essentially, is to try to provide some meaningful opportunities for these kids so they don't just stay on the streets. I mean, that is the concern.

Mr. CRANE. I mean, are you going to establish some guidelines of what you expect those kids to do?

Mr. PANETTA. Yes. We want to make sure that the programs do, in fact, provide meaningful work for these kids, but, secondly, that they are targeted in terms of the kids that are going to be put to work. Thirdly, we want to see plans from these communities as to how they are going to spend this money.

Mr. CRANE. I just met with some people from Lake County. They have programs set up there where they are working in conjunction with Baxter, Abbott and Motorola to give these kids specialized training. Wouldn't that money more constructively be used by guaranteeing that those kids take advantage of that kind of a curriculum during the summer? I mean, if we are going to spend the money, give them the training and the qualifications, to work in meaningful jobs that are available.

Mr. PANETTA. I think that is the kind of opportunity we would like to look at.

Mr. CRANE. One other thing I would like to touch upon. President Salinas—I think it was back in 1986—inherited about a $100 billion deficit for Mexico which was staggering, and last year he came in with a surplus with no tax increases. One of the ways in which he accomplished that miracle was privatization with a vengeance. Have you given any thought to selling off, for example, TVA, or selling off Federal lands that are not being designated for parks or potential park expansion in the future? Have you given any thought to that?

Mr. PANETTA. You know, we did an interesting thing in the budget agreement where we said that any asset sales cannot be counted toward deficit reduction. So the answer to your question is, we did not look at assets.

Mr. CRANE. It seems to me that would be infinitely preferable to considering tax increases first.

Another item is subsidies. Wool and mohair and honey over 5 years will get over $1 billion, dairy products will get well over $1

billion in the same timeframe. Have you looked at these expenditures critically with a view to lowering the tax burden because we have lowered the spending outlays? Have you given that some thought?

Mr. PANETTA. Yes. In our proposal we eliminate the honey program, and we trim the amounts that are provided——

Mr. CRANE. Do you trim wool and mohair?

Mr. PANETTA. Trim wool and mohair, so to speak.

Mr. CRANE. Well, I thank you for your effort here, and, as you know, you have got all the Republicans with you on spending cuts. But I have had the same experience Sandy Levin had in my district this past weekend, and, overwhelmingly, they are saying, make the cuts before you come back and hit us with a tax increase.

Thank you very much, Leon.

Mrs. KENNELLY [presiding]. Mr. Andrews of Texas will question.

Mr. ANDREWS. Thank you, Madam Chairman.

Good morning, Leon. It has been a long couple of weeks. I just wanted to comment on what the Democrats in the Budget Committee did last night, and to get your thoughts about it.

Last night the Democrats agreed to an additional $63 billion in cuts, which means a 1-to-1 ratio in spending cuts to tax increases over the next 5 years and a freeze to discretionary spending through 1998. The discretionary outlays will be less than the 1993 outlays every year through 1998. The cuts include an additional $3.5 billion in the fiscal year of 1994 beyond what the administration has asked. These cuts will ensure that the 1998 deficit will be $144 billion less than under current spending.

We have considered some of the concerns that were voiced here today. But be assured, we don't count taxes on Social Security benefits as a cut in spending. We count it as a revenue increase, and we use the 1993 defense outlays instead of the 1994 outlays used by the administration. We have really tried to move farther than the administration has on cuts.

Mr. Crane is right. Americans want to see the administration and the Congress find more cuts. I have found the same response in my district that Sandy and others have heard across the country. The Budget Committee last night tried to move to do that. I wonder what your opinions are? How do you think the President will receive these additional suggestions, and what do you think it means in the overall picture?

Mr. PANETTA. The President commends both the House committee for the work it is doing as well as the Senate Budget Committee because you are both working on the same track in trying to come up with additional spending cuts. And he commends the process that you are going through. Obviously, there is a lot to shakedown here as you go to the Floor between the House and the Senate and what the ultimate package will be, but he thinks that the process is the right one. You are moving in the right direction. We would like to continue to work with you as we fashion that package.

We don't want you to lose sight, however, of the important principles behind the economic plan. There is a need, again, to provide this short-term stimulus to the economy. There is a need to make some important investments in our society. And you can't lose sight

of that. We appreciate the language you put into the budget resolution that states that you support the President's investment package.

Thirdly, you have got to deal with deficit reduction. You are making some tough choices, and we appreciate the fact that you are doing that.

Mr. ANDREWS. Just one more comment. The enhanced rescission aspects, especially giving the President the right to make specific cuts during the appropriation process, will give us all a lot more credibility than we have had in the past. I would hope that the President, at the earliest possible time, will, in one of his future talks to the Nation, speak about the importance of enhanced rescission and what he plans to do with it. I think it would be a very positive statement to the markets and to the American people.

Mr. PANETTA. As I indicated, I will be testifying on behalf of the administration before the Government Operations Committee in support of the enhanced rescission approach. We are hoping that that legislation can move quickly. The President has said that if the House and Senate pass that legislation, he will sign it.

Mr. ANDREWS. Thank you.

Mrs. KENNELLY. Mr. Lewis of Georgia will question.

Mr. LEWIS. Thank you, Madam Chair.

Leon, I am delighted to welcome you. It is very good to see you here. You are a superb person for this major responsibility in this administration. I want to commend you and the President for your courage. You are taking some very important steps toward getting our Nation's economy back on track. It took a lot of courage, and it took vision that was a long time coming.

I know, as my colleague from Texas just stated, we have got to make some real cuts, some deep cuts, and we are going to have to increase revenue, new taxes. It is going to hurt some people, maybe, a little. It is going to hurt a few programs.

I want you to know that I support—this gentleman from Georgia supports the defense cuts. This is one gentleman from Georgia who supports the defense cuts. I believe the Cold War is over. The Berlin Wall is down. The Russians are not coming. They are gone. And, if anything, we probably should cut it some more.

I want to take just a moment to read to you some excerpts from letters from three citizens of my district. Cynthia Skidmore wrote, "Please, please do not let the consideration of this package become a political football." Bonnie Rivers wrote:

> There are those of us that are willing to bear our share of responsibility in the form of increased taxes and spending cuts to assure that America remains healthy and the basic needs such as access to health care are met.

And Joan Wyman wrote, "I and my family are ready to take the medicine for our debt."

I think these letters express my feeling and those of the majority of the people in the Fifth District of Georgia. We are ready and willing to help, and I am going to say to you and the President that you will have my help and my support. I said to you the other day when we met at the White House, that I liked your emphasis on long-term investment in rebuilding America, that our cities are in trouble. Our cities are becoming unlivable, are becoming like jungles. Too many people have been left out and left behind.

I said yesterday that this is the 25th year since the assassination of Martin Luther King, Jr., and Robert Kennedy, 30 years since the March on Washington, and we are still a Nation divided. So we need to spend more of our resources in rebuilding the lives of the American people, and I hope you lead this administration in that direction.

Thank you, Mr. Director.

Mr. PANETTA. Thanks very much.

Mr. LEWIS. Thank you, Madam Chair.

Mrs. KENNELLY. Mr. Herger of California.

OK. Mr. Camp.

Mr. CAMP. Thank you.

Leon, you and I served on the Agriculture Committee together, and my questions really have to do with the agriculture portion of this proposal. I have a couple of questions, but my first one is this: Has the administration done a comprehensive analysis of the impact on U.S. agriculture relative to all of the various tax proposals in this package, the inland waterway tax, the Btu tax, and other user fees? Is there a comprehensive analysis?

Mr. PANETTA. Specifically on that, I do not believe that we have an analysis just on agriculture. In other words, we haven't just looked at that segment of the economy and said, these are the implications across the board.

We have, obviously, in developing the package wanted to make sure that no region of the country was adversely affected, that everybody was treated as equitably as possible. On the agricultural side, obviously, when you are trying to target subsidies those programs are the target of almost every budget that seeks to limit subsidies. You almost always wind up looking at agricultural programs. We are trying to see if there is a better way to target those subsidies, one.

Two, we put them into place—most of the agricultural reductions take place in the outyears. By that I mean we are looking at 1996, 1997, so that the Congress will have the opportunity to work with those proposals as part of the farm bill. And, in addition to that, we are providing a rural development initiative that we hope will meet some of the needs we see in rural America as well.

So, overall, we don't think that agriculture is targeted here in terms of adverse impact. They are sharing, obviously, their share of the burden, and it is a heavy burden that they carry, but we think it is in line with what we are trying to do overall in terms of the economic program.

Mr. CAMP. Well, since there is now a comprehensive analysis and studies show that since 1981 agriculture has already contributed—and that is your word—$57 billion in Government supports, then the direct and indirect impact on farm country is very severe. Some studies have shown that the energy tax proposals alone in this package would cost the typical Midwestern corn farmer $1,600 a year. So in your earlier comments about fairness and contributions from various segments of the country it appears to me that the farmer and the family farmer, particularly the small farmer, is being singled out for a disproportionate share of the burden under this plan.

Mr. PANETTA. Again, what I would ask you to do is to look at the overall approach here. What we tried to do with regard to the ag programs was to target subsidies that we think, frankly, ought to be directed at the smaller farmer. For example, on wool and mohair, that is a program in which we provide direct subsidies to those who raise crops in that area. What we tried to do is say we ought to limit payments under that program to $50,000 to those smaller guys that are involved in that kind of production.

With regard to the overall CCC targeting, we think that we ought to target farmers who have less than $100,000 of nonfarm income. That is targeting benefits to the small farmer. It is targeting for saving the subsidies of the big guy.

The same thing is true with regard to some of the other targets that we have here, honey program, et cetera. I recognize that when you look at things like the Btu tax that, obviously, for those businesses that are energy intensive, even though this is a broad-based tax, it is going to produce some additional costs in those areas, but at the same time you have to ask yourself the fundamental question, what are we trying to do here? We are trying to deal with a huge deficit problem. Everybody has to participate.

I know that farmers are being asked to make some sacrifices here, but we are asking everybody to make some sacrifices. So I guess it is in that spirit that we need to try to address this problem.

Mr. CAMP. One last question. On the rural development initiative, have certain areas of the country been identified yet with regard to that initiative?

Mr. PANETTA. Which initiative? I am sorry.

Mr. CAMP. Well, the enterprise zones particularly.

Mr. PANETTA. No, actually, this committee will probably have a lot to do. The administration will be making some requests. It will be very similar to what we did in H.R. 11. I think they are looking at maybe 50 enterprise zones, something in that vicinity. But as to where those would be located and targeting of that, I think what I would do is ask Secretary Bentsen for specifics on that to work those out.

Mr. CAMP. Is there any designation between rural and urban areas under that?

Mr. PANETTA. I believe the hope is that they would be balanced between rural and urban America, similar to what was done in H.R. 11.

Mr. CAMP. Thank you.

Mrs. KENNELLY. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Panetta.

Mr. PANETTA. How are you?

Mr. KOPETSKI. Better than you, probably.

Let me ask you a couple of questions. We are doing a lot in the President's package. I am very supportive of; it just needs some refinements. There is some good help there for small businesses, which are engines in our society. Why not extend capital gains tax further so heavy industrial users can think long term? That is what we need in this economy, is longer term investment.

Mr. PANETTA. Again, the President felt that the combination of doing an incremental tax credit which applies to big and small

businesses in those first 2 years would provide some important investment stimulus there. But as far as permanent features in the Tax Code, those ought to be targeted more towards small businesses.

That is true for the incremental tax credit, where there is a permanent small business incremental tax credit in this, but also capital gains targeted at small businesses as well. His feeling was in terms of more permanent features here, we ought to try to target smaller businesses.

Mr. KOPETSKI. If we had the money, do you think the President would want to extend it to large businesses as well?

Mr. PANETTA. If we had the money, there is a lot we need to do. That is something we need to evaluate as we go through the tax package, whether or not you can expand that and not add to the revenue loss.

Mr. KOPETSKI. Is it good energy policy—Mr. Neal talked about oil—is it good energy policy to tax at the same rate, or even heavier, a highly efficient form of energy production such as water, higher than dirty, rotten, inefficient, dangerous fossil fuel?

Mr. PANETTA. Is that a leading question?

Mr. KOPETSKI. Yes or no. Let's talk about the energy policy. We are going to tax hydro worse or at the same rate as oil. Is that good policy?

Mr. PANETTA. Let me track you through our thinking. Obviously we looked at several possible approaches here. Our concern was, for example, the carbon tax, if you are going to tax those products that produce greater impact in terms of the environment, you would have an adverse impact regionally in terms of parts of the country. So that was the concern on that.

We looked at a gas tax, and the concern was that a straight gas tax would impact on the more rural areas of the country.

We looked at an ad valorem tax, and the concern was on a broad-based ad valorem, it would not have any features of it that would be tied to energy usage, to energy efficiency and to consumption. That is what brought us to the Btu at that, a modified Btu.

Mr. KOPETSKI. I don't object to the Btu tax.

Mr. PANETTA. The exact nature of that formula is being worked on; it continues to be worked on.

I think there are ways to improve it, I agree with you. But I think our concern was that we do it in a way, again, that doesn't have an adverse impact on particular regions of the country while emphasizing to the extent possible more energy-efficient fuels.

Mr. KOPETSKI. I am going to take that as a "yes" back home.

Mr. PANETTA. Yes.

Mr. KOPETSKI. Thank you.

Let me ask you—I have got a little more time here—to go back to the alternative minimum tax. I think it is very positive that the President and you folks are making some adjustments in that area. I think there is about 25 percent of the companies there probably shouldn't be, it wasn't designed for them, so we are trying to provide some relief.

But the problem is, investment tax credit doesn't help those that are in the AMT. I guess, you know, is there some room to work in terms of further refinements of the AMT itself?

Mr. PANETTA. Absolutely. I think the Department and the administration would like to continue to work with the committee to see if there are better ways to fashion those proposals.

Mr. KOPETSKI. Thank you, Mr. Panetta. I will stop right there.

Mrs. KENNELLY. Mrs. Johnson.

Mr. Santorum.

Mr. SANTORUM. Thank you, Madam Chair.

Mr. Chairman—I can't stop calling you that—it was a pleasure serving with you in my first 2 years on the Budget Committee.

Mr. PANETTA. I still call myself Congressman.

Mr. SANTORUM. I could use up all my time in accolades for the President's choice of you as Budget Director, so I will get down to brass tacks.

I see this as possibly a missed opportunity. The President came before the Republicans in the Ways and Means Committee and the Appropriations Committee and said to us that he would have preferred making all spending cuts and no tax increases if he could have.

Now, that is not what you said earlier. You think you needed a balanced package. But what the President said to us, is that he would have preferred to come to the Congress with all spending cuts and no tax increases, but felt—was advised, was told somehow that this couldn't pass the Congress.

Yet, I am hearing that Members of Congress—even on the Democratic side of the aisle—are saying, "This is way too shy on spending cuts." Wasn't there really a better chance for leadership here? Couldn't he have really come to the Congress with a tougher deficit reduction package, with more cuts in Federal programs, with real change in Government, and been successful? Isn't this really just a timid approach from what you are hearing from the Congress?

Mr. PANETTA. I sure don't hear that.

Mr. SANTORUM. Mr. Chairman, you just heard Mr. Andrews say that the Budget Committee, your folks on the Budget Committee are coming forward saying we need more spending cuts.

Mr. PANETTA. Again, I think we have—on defense, I don't hear anybody saying we ought to do more on defense cuts.

Mr. SANTORUM. Except Mr. Lewis just said that.

Mr. PANETTA. On nondefense, the committee is I think working the nondefense number, but again, you have to be careful not to impact, it seems to me, on the areas that you want to do some investments in.

Third, on entitlements, if you want to do additional spending savings in entitlements, that leads you right to the retirement programs. I don't see any other room here.

So the answer, and I think the President basically was saying this, is sure, nobody likes tax increases, nobody wants to do tax increases.

Mr. SANTORUM. Was it ever on the table to try to do it all with spending cuts, or was that never considered?

Mr. PANETTA. We did this in the committee. We went through all the spending areas first before we turned to revenues. It was pretty clear after we went through all of the spending cut areas, particularly with the targets we had in mind, that we had to turn to the revenue side as well.

Mr. SANTORUM. OK. Second question. I wanted to respond to Mr. Coyne's question, which concerned the need for the stimulus part of the package. In your response to him, you gave four reasons, four problems we confront, for what we need the stimulus package. You said there are contractions in business, there are defense closures, continued unemployment, and the credit crunch.

What in the stimulus package addresses any of those issues? As far as I can read—I have read it over and over—I don't see anything that does anything about contractions in business except reincreasing taxes, which I think would lead to further contractions. There is nothing that does anything about defense closures—in fact you cut defense more, which causes more defense closures.

Now, I understand you did something about unemployment. We extended unemployment benefits. I don't think to the people who are on unemployment that that necessarily is an answer. That is a Band-Aid.

And you did talk to Mr. Bunning about the unemployment benefits coming under the caps, but as you know, the unemployment compensation is a pay-go item. It did not stay under the caps. It got added to the baseline in the pay-go area, and is really going to be a cost driver in the future.

So the fact that there is savings in the cap side under the discretionary part is really sort of eluding the question of when you add it to the deficit on the pay-go side.

Mr. PANETTA. On the question of the stimulus program, there is one thing that responds to all of the problems I just pointed out, and I think it is the one thing that concerns us all. It is called jobs. I mean, when you have contractions in business, people lose their jobs.

Mr. SANTORUM. I understand that, but there is a more fundamental concern there. What we want to do is expand business, not create Government jobs. Isn't that what we are looking at here when you say we have contractions in business. Don't we need to expand business?

Mr. PANETTA. The package is aimed at trying to give business that incentive as well. You also have to provide some meaningful jobs. What is wrong with providing highway jobs? What is wrong with providing jobs in public works projects? What is wrong with providing jobs in our communities? What is wrong with providing summer jobs? What is wrong with that?

Mr. SANTORUM. My answer to that, Mr. Chairman, is we don't have the money to do it.

Mr. PANETTA. Do we have the money to give tax incentives to businesss? What is the answer to that?

Mr. SANTORUM. I would agree with you. No.

Mr. PANETTA. You wouldn't give tax incentives to businesses either?

Mr. SANTORUM. We need to focus in on reducing this deficit, as you and I have discussed many times. There are other things we can do to promote growth outside the area of tax matters that have to do with Government regulation and its costs.

Mr. PANETTA. Again, I think it is important that you don't lose sight of the investment side as well, both in the private and public sector.

Mrs. KENNELLY. Does any other Member wish to question?

Mr. JACOBS. Thanks for coming.

Mrs. KENNELLY. Thank you very much for giving us your time. Thank you.

The committee will resume its hearings at 2 o'clock.

[Whereupon, the committee recessed at 12:55 p.m., to reconvene at 2 p.m.]

Chairman ROSTENKOWSKI. The committee will come to order.

This afternoon, the committee continues its hearings on the administration's proposal for public investment and deficit reduction. The administration has proposed bold and dramatic changes for this country in its economic package. We need to understand how these proposals will affect our economy and our citizens in both the short and the long term, as well as our ability to compete in global markets.

We look forward to the testimony of this afternoon of the Honorable Laura Tyson, Chair of the Council of Economic Advisers. We hope to learn from Dr. Tyson what effects the Council anticipates the administration's proposal will have on the economy, both domestic and international.

Welcome to the committee, Dr. Tyson. We are looking forward to your testimony.

I will yield to my colleague, Mr. Archer.

Mr. ARCHER. Mr. Chairman, I don't have an opening statement, but I want to welcome you also to the committee. We all have our hands full, and I look forward to your testimony.

STATEMENT OF HON. LAURA D'ANDREA TYSON, PH.D., CHAIR OF THE COUNCIL OF ECONOMIC ADVISERS

Ms. TYSON. Great. Thank you very much. It is an honor to be here and to explain this ambitious Clinton program and talk about the economic rationale.

I thought the way to start is really to focus on how we at the CEA thought of the underlying economic arguments for each of the three parts of the program.

As you know, the program contains an economic stimulus package, an investment package, a long-term investment package, and a deficit reduction package, and I would like to give you the logic, the economic logic behind each of those three parts.

As far as the economic stimulus is concerned, this is the use of a temporary set of tax incentives and Government spending programs to help the economy move more quickly back to its capacity level of output.

We are as a result of having at least 15 months of unemployment rates at 7 or higher than 7 percent, we really are allowing the Nation to suffer a terrible waste of our resources. If we simply produced at our capacity, we could be producing something like 4 percentage points more of output. So we are giving up output, we are giving up jobs, when we have a tremendous number of unmet needs in our society. So the main argument for economic stimulus is to help the economy get more quickly back to its capacity output.

We also know this economic recovery has stalled out once before, and we also know that compared to past economic recoveries, that it has been a slow economic recovery. We at the CEA did a com-

parison of this economic recovery with previous economic recoveries during the post-World War II period, and we discovered that indeed we are far under the number of jobs that would have been created if this had been a normal economic recovery.

Depending upon how you do the measurements, we are anywhere between 3 million and more than 6 million jobs short of where we should be if we simply had a recovery that was at a normal pace of recovery for our own history.

So we feel that given that the recovery has stalled out before and we still have substantial excess capacity in the economy, and that we are still underperforming relative to our own history, that a stimulus package is warranted.

In addition, of course, we believe that this stimulus package is both an insurance against a stallout, but it also is a downpayment on our investment program.

And finally, I would also like to say about the stimulus that there is really no risk here, it seems to me, of overheating the economy. This is an economy which had a substantial amount of excess capacity in it. It is an economy where the core rate of inflation is around 3 percentage points, and there is no real evidence out there of any acceleration in inflationary pressure.

So that we have an opportunity here to use a cautious, wisely formulated stimulus package consisting of about half investment tax credits for the private sector and half spending on public investment programs to bring us more quickly to our capacity level of output. So that is the economic rationale for doing a stimulus package.

The second part of the program, of course, is what we call the investment program. And this is a very ambitious program designed to increase both public and private investment spending in the United States.

Now, I want to start out with the rationale for this by indicating that economists widely believe—and I know my predecessor believed this as well as I—that over long periods of time, the fundamental determinant of a society's well-being, its real income growth, of how prosperous it is, is its rate of growth of productivity. That is the dominant mechanism for generating long-term, real prosperity.

The first thing I want to note in one of these charts we have put up here, if you look at the postwar period in the United States, you can see that we had a tremendous deceleration in the rate of growth of productivity, and a tremendous deceleration in the rate of growth of real hourly compensation.

That kind of chart, and there are lots of other ways one could demonstrate this, indicates the very close relationship between real income growth and productivity growth.

So the thing to look at next is what determines the rate of productivity growth. Well, the fundamental determinant of the rate of growth of productivity in a society is its investment, and its investment is both private investment and public investment.

So our investment package, the fundamental rationale for our investment package is the rationale of prosperity for ourselves and our children through getting us on a path of more rapid productivity growth.

Now, let me talk about the kinds of investments that are important to productivity growth. Again, this is not just in our own history. This is looking at other nations around the world.

We have private investment in plant and equipment as a very important determinant of productivity growth; investment in the skills and education of a nation's work force; investment in the Nation's technology and the diffusion of that technology; and investment in what you might call core infrastructure, which is transportation facilities, water facilities, utilities. Finally, an investment in health programs, which really you can think of as investment in the human capital that we have at our disposal. We need to have a healthy work force as well as an educated and skilled work force.

Now, the emphasis on investment and productivity leads me to postulate that we have an investment deficit in the United States. We have a private investment deficit and a public investment deficit. Our private investment deficit is best measured by looking at our investment rate in the business sector, in plant and equipment, compared to the investment rate in business sectors, in plant and equipment, in other advanced industrial nations.

If you look at that comparison over the past 20 to 25 years, the United States is the low investment country. So we have a deficit relative to our competitors in private investment.

We also have a deficit in public investment. And the second chart I have up here is just public investment as a percentage of GDP. What it shows is a declining trend in investment spending by Federal, State, and local governments as a share of our output.

This is actually a very staggering reality. While we have managed in the United States to have accumulated increasing amounts of Government debt, we have managed to get ourselves on a course where the deficit is growing as a percentage of GDP, at the same time governments have been spending less on those kinds of programs which are basically the foundation for future prosperity: education programs, infrastructure programs, civilian technology programs, and programs related to the health and well-being of the labor force.

So I want to emphasize here that our investment package is meant to deal with these twin deficits: the private investment deficit and the public investment deficit. And the public investment deficit is shown by the second chart there.

It is important to emphasize that this view of the world suggests that not all Government spending is alike. So one of the things we are proposing here in our three part package is not just to reduce the rate of growth of Government spending in the economy, not just to reduce the share of Government spending in GDP, which we are doing, but actually at the same time to shift fundamentally the composition of Government spending towards those kinds of programs which will give prosperity to ourselves and our children in the future.

The investment package that we put together consists of about \$160 billion over 4 years. A substantial amount of that, about \$100 billion, is in additional public investment programs; \$60 billion of that is in targeted investment and other tax incentives, enterprise zones, for example, all with the objective of investing in the public and private foundations of future prosperity.

Let me just give you a brief outline of the public investment sides of this. We have first of all a $48 billion package of spending on what we call Rebuild America, which includes infrastructure spending, civilian and technology spending, defense conversion spending.

We have a second part of the package called Lifelong Learning, $38 billion over 4 years. This really reflects the idea that in order to get the right skills in our labor force and the right flexibility in our labor force, we have to start from Head Start and move right up through a worker's lifetime to give them the possibility to train and retrain to deal with a very changing international competitive environment.

A third part of our investment program is what we call the rewarding work part of the program. This is where we have the expansion of the earned income tax credit. It is very important to give to American workers an incentive to work, an incentive to work hard, an incentive to be trained and educated to take on jobs.

The incentive is very much muted or undermined if it is the case, as it is in the United States, that a growing number of workers who work full time cannot earn enough to bring their family to a poverty level. And I daresay those same workers working full time who cannot bring their family to a poverty level income have a harder time providing the incentive for skills and education for their children.

So we must address this notion of giving people appropriate incentives to work. And that is what the rewarding work part of our investment package is about.

And then finally we have a spending package to address certain national health crises which affect the well-being of our work force, and these go from immunization of children through food stamps, through AIDS, through drug and substance abuse, through a number of public health crises that not only are social crises, but are also economic crises for the Nation.

Now, that is the public spending part of the investment package. The investment package, as I said, also includes a series of tax incentives to encourage private investment. And I am sure we can talk about them in detail. Just let me give you the ones I think are the most important.

A small business capital gains tax relief to encourage the formation of new small businesses: We all recognize the importance of the small business sector to the creation of jobs in the United States.

A flat small business investment tax credit: As you know, in the stimulus part of our program we have a temporary incremental tax credit, but this small business tax credit will be neither incremental—it will be an investment tax credit that will exist throughout the time horizon of our program.

We are asking for making the research and development tax credit permanent, something which we need if we are going to stimulate the success of our high-technology industries.

We have asked for the creation of 30 enterprise zones with wage credits, credits on the depreciation and expensing side with the provision of low-interest loans.

There are other parts of the package, but together these programs represent a targeted attempt to give tax relief in order to encourage businesses to undertake private investment and address what I was referring to as the private investment deficit in the country.

This finally brings me now to the issue of deficit reduction, the third part of the package. I think it is important to start out with some of the facts here. When we began to work on this package for the economy, we looked into the future and observed that the deficit as a percentage of GDP was going to be expanding over time, even as the economy recovered. Normally one's expectation is that when the economy recovers, the Government brings in more revenues, because of a healthier tax base, and the Government has to spend less on recession-related items like unemployment compensation or food stamps or Medicaid. So normally one hopes the deficit goes down when the economy expands.

But we have gotten ourselves on a path where the deficit was rising relative to output as the economy expands, something which is really not a path for economic prosperity. So it became essential to come up with a plan that would actually reverse that trend. And that is what we tried to do.

A second thing that disturbed us and made us feel it was essential to act was of course the interest burden of these ever-increasing deficits. The Government doesn't borrow money for free. It pays interest on what it borrows. In the last fiscal year, $2 out of every $3 the Government borrows went to pay interest on the debt. So we clearly had a deficit problem relative to the size of our economy.

Now, I think I want to emphasize that the reason deficits matter is not just because they are politically salient. That is not why they matter to an economist. Why deficits matter to an economist is because when the Government is running a large and increasing deficit relative to GDP, it must come into either the national or the international capital market and borrow to finance its spending.

And when it borrows to finance its spending, it essentially is taking resources which could be borrowed by the private sector and essentially pushing out or crowding out private investment. It is driving up long-term interest rates and keeping the cost of borrowing to American households, American citizens, American students, the American business community, it is keeping the cost of borrowing high for all of those actors.

So the reason for deficit reduction is to try to eliminate the Government's claims on savings and investable resources, creating lower interest rates for the private sector.

But notice, given my emphasis on public investment as another contribution to long-term growth, we want to come up with a deficit reduction package which reduces Government claims on investment resources; frees resources for the private sector, but also does not denude the Government of the capability of doing public investment, because public investment is a pillar of economic growth like private investment.

So the challenge is not just deficit reduction but deficit reduction in a way which preserves and allows the Government to increase its investment spending.

When we tried to put together a deficit reduction package, I would say we were looking for several characteristics to make the package be a sound package. First of all, it had to be big enough and sustained enough to be credible, and I mean credible with the American people and credible with domestic and international capital markets. We had to really reverse the trend and reverse it in a perceptible way.

If you see up there at the last chart, it takes the Federal budget as a percentage of GDP and cuts the deficit in half in 4 years. We have been very gratified by what we believe to be a vote of confidence in the credibility of our package that has come from capital markets.

Since November, if you look at the period of time and watch long-term bond rates, you will see they have fallen by 100 basis points, and much of that, most of that came with the announcement or the growing anticipation that we were going to have a serious deficit reduction effort.

The second thing about the package, as we tried to structure it, was balance. We were looking for an approach which touched in a significant way all major portions of American spending programs, was also balanced in terms of having both taxes and spending involved, was also balanced in terms of its regional effects and its income effects.

Finally, we were looking for an approach which had no gimmicks, magic asterisks, or rosy scenarios. We were very conservative in our estimates about growth rates. We were very conservative in our estimates about interest rates. We gave ourselves a harder task somehow so that our package would not be one with gimmicks.

Finally, we tried to structure a package which we believed would be passable, one which we could get the American people to support, and we believe by our reactions so far that the American people are very much in support of the general approach we have laid out.

Now, since I have already used up a fair amount of time, let me just instead of going into detail in the package, let me just once again emphasize a couple of criteria that we employed in putting together the package.

We did look across all spending items, so if you look at our proposed 1997 numbers, for example, you will see that we propose in 1997 $37 billion in defense cuts, $20 billion in nondefense discretionary, $34 billion in entitlements, $7 billion in Social Security, and $14 billion in the interest payments on the debt. No part of the spending categories of the Government is left untouched.

Second, we also tried to be very specific in the items that we laid out. So instead of having an asterisk or a gimmick, we have page after page of spending items with the estimated saving from the particular spending reduction we have proposed.

On the revenue side, let me just give a couple of points about the revenue package we have put together. On the energy tax, I would like to emphasize that this tax is not simply a revenue raiser. It is there because we believe that an energy tax will have other beneficial effects for us. It will encourage conservation; it will help control CO_2 emissions; it will help reduce our dependence on oil im-

ports. Compared to all other advanced industrial countries, we are very much undertaxed on energy.

This is a relatively small tax on energy which will raise revenue for deficit reduction, but it will also have beneficial effects on these other energy conservation items.

Finally, on the income tax increases we have proposed, we were looking not simply for ways to raise revenue but also for ways of restoring some of the progressivity into our income tax rates that had been reduced during the 1980s.

I guess I will end here by saying that I view very much the package as a coherent whole. I don't like in general the notion of sort of taking out individual pieces, because deficit reduction is only a means to the end of more investment, both private and public. The stimulus is also a means to an end of more investment by encouraging the economy to recover and by using investment incentives to get the economy to recover.

So finally, I see the whole package very much linked together by the goal of future prosperity, by the goal of investment, both public and private, as a way to get to future prosperity. Deficit reduction becomes one of several means to that end of more advancement and a better future for America.

Thank you.

[The prepared statement and attachment follow:]

Remarks by Dr. Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the
Ways and Means Committee
U.S. House of Representatives

Tuesday, March 9, 1993

Thank you, Mr. Chairman, for the opportunity to testify before the Ways and Means Committee.

The election of 1992 was a clear mandate for change--in particular, economic change. No wonder voters expressed this preference. A number of disturbing economic trends have developed in recent years. Let me name just a few of them: median family real income has been stagnant--its 1991 level was actually below the level reached in 1979--despite more two-earner families; the poverty rate in 1991 was higher than in any year during the 1970s; the Federal Government is borrowing to pay almost a quarter of its current bills; and escalating health care costs are burdening firms and workers as never before. It is little wonder that the voters gave a mandate for economic change.

Underlying these disturbing trends are three fundamental problems in the American economy: a recovery so anemic it is only beginning to show signs of substantial employment growth in its twenty-third month; an erosion in the growth rate of productivity over the past twenty years; and an increase in inequality that has undermined the sense of fairness in our economic system.

The President's three-part economic package--consisting of a short-term stimulus, an investment program, and a deficit reduction plan--is designed to correct each of these fundamental problems. The short-term stimulus is intended to ensure a sustained economic recovery that is strong enough to generate employment growth. The investment and deficit reduction components of the package are directed toward boosting productivity growth and living standards over the long-term. All elements of the package are designed with an eye toward restoring basic fairness to the system. Let me elaborate on the President's plan in the context of our fundamental problems.

Economic Stimulus

The United States economy has experienced a protracted period of weak performance. Since 1989, the average annual rate of GDP growth has barely exceeded one-half of one percent--inadequate to keep up with population growth. This period was marked first by sluggish growth in 1989 and early 1990, then a recession which lasted from July of 1990 until March of 1991, and finally a very slow recovery since March of 1991. The recovery has been so slow that most Americans have barely noticed it is underway. In the third quarter of the recovery, the economy showed serious signs of falling back into recession--real GDP grew by only 0.6 percent and real gross domestic purchases actually declined.

Some observers have used recent good news on the economy as an argument against the stimulus part of the President's plan. However, these recent releases must be placed in their broader economic context. For example, last Friday the Labor Department released data on the employment situation for the month of February that showed strong growth in employment, measured by both the household and payroll surveys. A careful look at the numbers, however, reveals that 90 percent of employment gains were concentrated in involuntary part-time employment--people who are working part-time, but desire full-time work. Furthermore, employment growth in the current recovery remains 6.4 percentage points below what it has been in the first 23 months of the typical post-World War II recovery--

which translates into a deficiency of about 7 million jobs at current levels of employment. The unemployment rate has exceeded 7 percent for 15 consecutive months and remains higher than the rate at the technical endpoint of the recent recession. This rate of unemployment translates into an output loss, relative to our capacity, of about 4 percent of GDP. That is simply unacceptable.

Many of the factors that contributed to recession or sluggish growth over the past four years are still acting to depress the economy. Many U.S. companies are in the midst of a painful restructuring process that will ultimately make them more competitive, but currently generates large permanent layoffs. This restructuring is manifest by the fact that the fraction of unemployed workers that have permanently lost their previous jobs reached an all-time high of over 45 percent in October of 1992. Ongoing and future reductions in defense spending will require a significant reallocation of resources that will continue to act as a drag on the economy. This process actually began in the late 1980s, and before it is completed may well involve a shift of over 3 percent of our GDP from military to civilian purposes. In several parts of the country the commercial real estate market remains considerably depressed, a consequence of overbuilding that occurred in the 1980s. There is little hope that commercial real estate construction will return to 1980s levels anytime soon. Also, a number of our trading partners have experienced much slower growth in recent months and that has reduced growth in our exports. Real GDP in both Germany and Japan, for example, declined in recent quarters. Furthermore, reduced withholding of taxes last year will reduce tax refunds this spring, and this is likely to make consumer spending unseasonably low. For all of these reasons we cannot be overconfident about the continued strength of the recovery.

And for all of these reasons, President Clinton's economic plan includes a stimulus package of spending increases and targeted tax cuts to spur investment and job growth in the near term. The short-term stimulus package is best viewed as an insurance policy designed to make sure that recovery does not falter again, and as a downpayment on the investment plan that will largely occur in subsequent fiscal years.

Three criteria have guided the design of this package: the potential for rapid spend-out rates; consistency with the investment program; and modest size. All of the items included in the package are fast-acting and job-creating. The unemployed have already waited far too long. All of the items included in the package are worthwhile on their own merits and are consistent with the basic long-run goal of shifting public expenditure toward investment. In that sense the package can be appropriately thought of as a downpayment on the Administration's overall long-run investment program. The size of the stimulus is limited by the deficit problem we have inherited--a problem that has proven to be much larger than anticipated--and by the fact that economic growth has picked up in the last two quarters. The modest size also reflects a desire to avoid overstimulating the economy in the event that the current recovery does continue at the pace of the last two quarters.

Our economic stimulus program comes to about $30 billion, composed of roughly 50% spending increases and 50% tax incentives. The spending side of the package includes increased funding for the following programs: extended unemployment benefits, highway construction, a summer jobs and training program for underprivileged youth, community development block grants, education programs, wastewater cleanup, and important environmental and technology programs. All of these programs are consistent with the philosophy of investing more in our people and our infrastructure.

The tax incentives are mostly in the form of investment tax credit programs for large and small businesses. The investment tax credit is incremental and temporary for large businesses (over $5 million in gross receipts). The basic rate is 7% (smaller for shorter-lived assets) on all equipment investment above 70% of a

historical base (a three-year average) in 1993 and 80% of that same base in 1994. The credit applies to equipment put in place between December 3, 1992 and December 31, 1994. Small businesses, which would presumably find the recordkeeping of an incremental ITC burdensome, are given a 7% ITC from the first dollar for two years, dropping down to a permanent 5% ITC thereafter.

The Administration estimates that the stimulus package, taken by itself, will add about 0.3% to the annual growth rates of real GDP in 1993 and 1994, creating about 500,000 additional jobs by the end of 1994.

The Nation's Long-Term Problems

Sustainable increases in the Nation's standard of living can only be attained through rising levels of productivity. As the amount of output per worker increases over time, so does the potential consumption per worker. Because of this linkage, the rate of productivity growth is a crucial indicator of how living standards will change over time.

From the end of World War II until 1973, productivity grew at an annual rate of about 2.5%, which implies a doubling in the standard of living in just under 30 years. The notion that each generation could leave its children a better place and a higher living standard was virtually taken for granted. Not any more. Since 1973, the average annual rate of productivity growth has fallen to about 0.8 percent, which implies that living standards will double every 90 years. The slowdown may be exaggerated to some extent by our inability to measure productivity growth in the rapidly growing service sector of the economy, as some observers claim, but a substantial portion of this slowdown is a consequence of adverse economic events and policy choices that have promoted consumption rather than investment.

Intuitively, our productivity increases with improvements in technology or the skill of our workforce and with increases in the amount of plant, equipment, and infrastructure our workers use in the production process. All of these driving forces of productivity growth require that we make investments--investments in research and development to improve technology; investments in health, education, and training to improve workers skills; and investments in buildings, machines, roads, bridges, railways, airports and the like to increase our Nation's capital stock.

The amount of investment that the Nation achieves depends directly and indirectly on government actions. Many government programs contribute directly to the stock of public capital--health care, education, training, and infrastructure spending, for example. Other government policies, especially tax policies, indirectly influence the amount of spending on private capital--research and development, plant, and equipment--that firms choose to undertake.

Policies of the last twelve years have eroded productivity growth in the economy by undermining both public and private human and physical capital formation. Conventional measures of public investment as a share of GDP have fallen each decade since the 1960s. Furthermore, the large budget deficits required to finance growth in defense and other non-investment government spending programs during the 1980s have reduced the pool of resources available for private investments in human and physical capital. We must reverse the fiscal policies of the last twelve years in order to increase capital formation and the rate of growth in our living standards. The investment program and the deficit reduction plan are intended to accomplish these objectives.

The Investment Program

The investment program includes a wide range of items that have benefits that will be felt over long periods of time, and thus, fit the conceptual definition of

investment. The Clinton investment package delivers on all of the major public investment initiatives promised by the President during his campaign--initiatives to put people back to work; initiatives to facilitate lifelong learning from childhood through retirement; initiatives to reward work for those who work hard and play by the rules; initiatives to address urgent public health problems; and initiatives to encourage private-sector investments that provide technological gains and improved productivity.

The investment program totals $160 billion over four years and addresses the President's major campaign promises under the following headings:

REBUILD AMERICA: $48 billion over four years concentrated in six key areas:

- o Transportation infrastructure ($8.4 billion), which includes full funding of the Intermodal Surface Transportation Efficiency Act and investments in mass transit, high speed rail, and airports.

- o Technology ($17.0 billion), which will fund the National Science Foundation, science, engineering, and technology grants, high performance computing, and extension of the research and development tax credit.

- o Environment ($8.0 billion), which will fund water cleanup, environmental technology, weatherization grants, forestry research, and natural resource protection.

- o Energy ($3.0 billion), for energy conservation and renewable energy programs, fusion research, and more energy efficient Federal buildings.

- o Housing and Community Development (9.6 billion), for Community Block Grants, fifty enterprise zones, assisted housing, and extension of the low-income housing tax credit.

- o Rural Development ($1.5 billion), for priorities such as rural water and waste loans and grants and community and business development for rural areas.

LIFELONG LEARNING: $38 billion over four years for education and training of people from early childhood through adulthood. This includes some measures intended for defense conversion:

- o A National Service Program ($3.0 billion).
- o Full funding for WIC ($1 billion).
- o Full funding of Head Start by 1999 ($3.7 billion).
- o Education reform and initiatives ($3.2 billion).
- o Worker training programs ($4.1 billion).
- o Youth apprenticeship programs ($0.5 billion).
- o Parenting and Family Support ($0.5 billion).

REWARDING WORK: $25 billion over four years, mainly accounted for by a dramatic increase in the Earned Income Tax Credit (EITC). The EITC is simplified and greatly liberalized. It is extended for the first time to workers without children--at a 7.65% rate that offsets the employee portion of FICA taxes. And the credit for workers with children is enriched enough so that a family of four with a parent working fulltime at the minimum wage is lifted up to the poverty line. This category also includes emergency unemployment compensation benefits and a crime initiative.

HEALTH CARE: $26 billion over four years for AIDs, women's health, drug and substance abuse prevention and treatment, nutrition assistance, USDA food safety

initiative, VA medical care, and improvements in Social Security disability insurance processing.

TAX INCENTIVES: $24 billion over four years to encourage private investment through investment tax credits, alternative minimum tax relief for corporations, targeted capital gains relief for small start-up businesses, and real estate investment incentives.

Some will argue that these expenditures are not all investments, that one government program is much like another.

This argument simply does not hold water. There is a big difference between Head Start, which we are fully funding, and a subsidy for honey, which we eliminate. A dollar invested in Head Start can avert as much as $6 in spending for special education, crime and income support. We will invest in the things that improve future living standards for us and our children.

This program will stimulate private and public investment in order to increase our rate of growth in productivity and, ultimately, living standards. These new investments are a central part of the President's plan.

The Deficit Reduction Plan

Finally, in order to reduce the government's claims on credit markets, the President's economic package includes a credible deficit-reduction plan. Deficit reduction is not an end in itself. It is a means to greater capital formation, faster productivity growth and higher living standards. Deficits require government borrowing--either from the private sector, reducing funds available to private investors and consumers and raising their cost of borrowing, or from the rest of the world, so that in the future a growing share of our tax dollars will be used to pay off foreigners who lent us money.

The President's proposal features a four-year (FY94-FY97) gross deficit-reduction program that is phased in gradually. By FY97 the plan will cut nearly $200 billion from the deficit, with $112 billion in spending cuts and $83 billion in revenue increases. After allowing for the $55 billion in new investment initiatives that will be introduced as part of the investment package in that year, the program achieves a net deficit reduction of $140 billion from the baseline deficit in FY97 alone.

The President's proposed multi-year budget has no plugs, caps, gimmicks, or magic asterisks. All cuts are identified in the OMB document "A Vision of Change for America." The 150 specific spending cuts reduce Federal government spending by $247 billion over 4 years. The spending cuts are nearly matched in magnitude by specific revenue increases.

The spending savings in the President's plan are in six general categories: terminating programs that don't work or are no longer needed; eliminating subsidies for wasteful programs and charging fees for government services; managing government for cost-effectiveness and results; controlling health care costs; adjusting defense spending to new post-Cold War realities; and asking for shared contributions from all Americans.

We have taken the first steps toward changing our economic course within the Federal Government itself. It is only fair that if we ask Americans to contribute, that the Federal bureaucracy make the first contribution. From the White House on down, every department and agency is affected. President Clinton has directed a 25 percent reduction in the staff of the White House, and the elimination of 100,000 positions in the Federal Government workforce.

Some of the larger items in the long list of spending cuts are:

- o Defense spending reductions of $37 billion in FY97 and $76 billion over a 4-year period.

- o Reduction of federal pay, retirement benefits, the number of civilian employees, and administrative budgets of departments agencies for a total savings of $11.7 billion in FY97.

- o Reduction of social security benefits for taxpayers above $32,000 (joint) or $25,000 (single): $6.9 billion in FY97.

- o Change the maturity structure of the national debt: $3.9 billion in savings in FY97.

- o Savings in Medicare and Medicaid (the sum of 33 programmatic changes, virtually all of which cut provider reimbursements); $17.7 billion in FY97.

- o Auctioning part of the Federal Communications Commission spectrum: $2.1 billion in FY97.

A large portion of the additional revenues raised in the President's plan are attained by increasing taxes on the very wealthy, who have benefitted most from the reduced taxes of the 1980s. This burden sharing is also consistent with the President's desire to reduce the growing gap between rich and poor.

Personal income tax rates are raised for approximately 1.2% of returns with the highest taxable income as follows:

- o A 36% bracket begins at $140,000 for joint filers ($115,000 for singles).

- o A 39.6% bracket begins at $250,000, regardless of filing status.

- o The maximum tax rate on caoital gains remains 28%, as under current law.

- o The Alternative Minimum Tax (AMT) becomes two-tiered: 26% up to $175,000 of AMT income and 28% thereafter.

All these rate changes are estimated to raise $26.3 billion in FY97.

In order to raise revenue, encourage the conservation of energy, and reduce harmful emissions, the President's plan also includes an energy tax that is phased in gradually. When fully effective, the proposed new energy tax will be 25.7 cents per million BTU, with an additional 34.2 cents per million BTU on oil. These amounts are indexed, so that the tax rises slightly with the rate of inflation. The tax is phased in in three stages: one-third in July 1994, one-third in July 1995, and the final one-third in July 1996. Estimated impacts on retail energy prices are 3-8%, depending on the specific product. But the tax will be levied and collected at the source (production or import).

Many are concerned that the energy tax increase will have adverse effects on inflation in the economy as a whole. These fears are unfounded. A variety of calculations suggests that the BTU tax will increase the rate of overall inflation by about 0.2 to 0.3 percentage points. This is consistent with historical experience. When energy prices rose 50 to 60% in response to the oil price shocks of the 1970s, the rate of inflation increased by about 4 percentage points.

A higher tax rate is placed on oil for two reasons. One is as a national security surcharge. A hidden cost of dependence on foreign oil sources is the additional money that must be spent on foreign aid and national defense in order to protect our strategic interests. This surcharge makes consumers of oil bear part of that burden more explicitly. The second reason for the higher rate on oil is that a straight BTU tax would burden natural gas (a less polluting source) more heavily than oil (a more polluting source). In order to discourage consumers from substituting to the more polluting source as a result of the tax change, an additional levy on oil was required. Hence the oil supplement corrects two negative "externalities" associated with oil consumption.

The BTU tax is estimated to raise $22.3 billion in FY97, after netting out roughly $7 billion in reduced income and payroll tax receipts that Treasury revenue estimators assume will result from the tax. In addition, the Administration proposes additions to Food Stamps, the EITC, and the Low Income Home Energy Assistance Program (LIHEAP) to offset the burden of the energy tax for low and moderate income households. These additional programs cost roughly $10 billion, and ensure that families with incomes below $30,000 will face virtually no net tax increase.

The basic corporate tax rate is raised from 34% to 36%. In addition, a number of tax preferences and deductions are reduced or eliminated and tax enforcement is increased. Total revenue accruing to the government from these sources is estimated to be $14.1 billion in FY97. In addition, a variety of other changes in "business taxes" (which can appear on either personal or corporate returns) nets $8.4 billion in 1997.

The health insurance portion of the payroll tax will apply to all earnings, rather than being capped (as at present) at $135,000. The revenue yield from this change in FY97 is projected to be $6.8 billion.

A brief rundown of the key features of the President's deficit reduction plan verifies that these spending cuts and revenue increases are real and identifiable. But the budget game is a complicated one, and this is only the first step we have taken to make the package credible.

To allay any fears of "rosy scenarios," the budget projections are based on a highly unusual procedure: We use the pessimistic forecast of the CBO, rather than the Administration's more optimistic forecast--even though the latter virtually matches the current Blue Chip consensus (see Table 2). Under the CBO's pessimistic forecast, the deficit falls from 5.4% of GDP in fiscal 1993 to 2.7% in 1997. Under the Administration's forecast, the deficit falls even further--to 2.2% of GDP in fiscal 1997--because of the higher level of GDP that is attained and the increased tax revenues and reduced mandatory expenditures that accompany a healthier economy.

Finally, a credible plan requires an enforcement mechanism. Under the President's plan, we propose to extend the Budget Enforcement Act, with continued caps on discretionary spending, "pay-as-you-go" requirements, and sequesters when necessary.

The President's plan is a bold one, but of course it is only the beginning of a long budget process. We welcome your ideas about how to improve this package. While no one will be happy with everything in this package, let me underscore the President's view that our deficit reduction goals will never be attained unless we are willing to view these hundreds of specific proposals as a single package. If we are going to restore a proposed spending cut, we must propose specific alternatives to take its place.

If the Congress enacts this deficit reduction plan, the results will be dramatic. But the reality is that deficits will begin to climb back up toward the end of the decade. The primary reason is skyrocketing health care costs. As a government and as a society, we must reform health care to ensure quality, affordable care for all Americans. Health care costs threaten the security of families, businesses, and government alike. We must also act to control health care costs if we hope to control deficits in the long term.

How the Package Promotes Fairness

All three elements of the package will help restore a sense of fairness. The stimulus will promote job opportunities for some of the 9 million unemployed members of our labor force. Since the investment program includes a number of programs, such as head start, WIC, health care, worker training and retraining, education and the earned income tax credit, that directly increase opportunities for the most disadvantaged members of society, it will also help level the playing field. Finally, the manner in which revenues are raised for deficit reduction will ask the most from those who can afford it--the top 1.2 percent of American income earners. All of these features of the total package will help restore a sense of fairness in our system and give meaning to the American dream for those members of society who were left behind by the policies of the past twelve years.

The Economic Outlook

Forecasting economic performance is not an easy task. As the budget process reminds us, there are many uncertainties which will have a great impact on the future path of the economy. What is more important than any specific predictions CBO or the Administration makes about economic performance is that we make sound choices about policy that raise the our investment rate, our productivity, and ultimately, our living standards.

As noted in discussing the budget estimates, the Administration forecast for real GDP growth is slightly higher than the CBO forecast on balance. In 1993 and 1994, the Administration forecast of 3.1 and 3.3 percent growth, respectively, corresponds exactly to the private Blue Chip consensus forecast. This is higher than the CBO estimates of 2.8 and 3.0 percent. The Administration forecast assumes that the stimulus package provides some additional growth in real GDP in the early years. As the stimulus wears off and the ITC for large businesses is eliminated, the Administration forecast falls slightly below the CBO forecast in 1995.

From 1996 through 1998, the Administration forecast essentially assumes that the economy begins to feel some of the benefits of a higher capital stock as a result of the investment program and the tax incentives provided in the stimulus. Consequently, while the CBO assumes that growth falls off to less than 2 percent by 1998, we feel that a long-run capacity growth rate of 2.5 percent is more realistic. In these "out years," the Administration forecast is identical to the Blue Chip consensus.

Mr. Chairman, this concludes my testimony, but I wanted to take a moment to thank you and your committee for your invitation and for your welcome. I look forward to working with you during my tenure at the Council of Economic Advisers. I know by working together we can all share in the effort to strengthen our economy by ensuring a stronger recovery, higher rates of public and private investment, and reduced Federal budget deficits.

Table 1. Comprehensive Budget Impact of the Package

	FY1997
BASELINE	$346
Spending Cuts:	-37
Nondefense discretionary	-20
Entitlement	-41
Associated debt service	-14
Subtotal:	-112
Revenue increases	-83
GROSS DEFICIT REDUCTION	-195
Clinton investment program:	
Spending	+39
Tax reductions	+15
Subtotal:	+55
NET DEFICIT REDUCTION	-140
DEFICIT WITH CLINTON POLICY	$206

Notes: This scores savings generated by increasing the taxation of social security benefits as a cut in entitlement. Some may prefer to count it as a tax increase.

Table 2. Comparison of Real GDP Forecasts

	Real GDP growth (Q4/Q4)					
	1993	1994	1995	1996	1997	1998
CBO	2.8%	3.0%	2.8%	2.6%	2.2%	1.8%
Administration	3.1%	3.3%	2.7%	2.5%	2.5%	2.5%
Blue Chip	3.1%	3.3%	2.5%	2.5%	2.5%	2.5%

Chairman ROSTENKOWSKI. Thank you, Doctor.

Do you leave any room for to us make any changes at all?

Ms. TYSON. I thought I would give you the economic rationale, but I am certainly willing to listen to all suggestions in terms of that economic rationale, absolutely.

Chairman ROSTENKOWSKI. Well, Dr. Tyson, about 1985, 1986, we wrote a tax bill here that was in the minds of many of us a simplification bill. Do you fill out your own income tax returns?

Ms. TYSON. No, I have an accountant fill out my income tax.

Chairman ROSTENKOWSKI. I read all your suggestions, and I am not suggesting that I disagree with them. With this wave of enthusiasm, the American people have shown that they are in support of this program, and I am afraid to disagree with it. But the fact of the matter is, investment tax credits, capital gains, enterprise zones, are we going to muck up the code at all?

Ms. TYSON. I think what we are trying to do here is to find a way to use the tax system to encourage those kinds of economic activities which the country most needs right now.

Now, using the tax system in a targeted way does indeed make the tax system more complicated. My answer to that would be, we are trying to strike a balance here between more simplification, which of course would make it easier, and incentives that are targeted.

Chairman ROSTENKOWSKI. And I don't want to disagree with that. I think if we can target areas where we have a slump in the economy or a problem in the industry, that we ought to do something like that.

But since I have been sitting on this committee, it almost always seems that once you give business or the taxpayer a break in an area like an incentive, there is no way that you can rescind that. It is like a sick patient. Once you give them all the medicine and they get cured, you send them out of the hospital, they don't take the medicine anymore. But American business starts making this a part of doing business. And that is what I always worry about.

I, for one, would like the private sector to do a lot more, and if Government, or more specifically, if in this committee we can create an atmosphere where they are going to do more, once they are well and active, then we can take the break away. It has always been a problem. Whenever you recommend that you are going to do something for a 5-year period, about the second year the business community is sitting down there saying: "Can you give us another extension for four more years?" And now it is not 5 years, it is 9 years. And that is what worries me about this.

I think that this is a bold package. I have endorsed it. I just hope that when we eliminate the deficit or curtail our spending, that we are broad enough to understand that good business, in my opinion, makes investment when the time and climate is right and not because we give them incentives.

Mr. Pickle.

I am sorry, Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Dr. Tyson, on your chart there I notice you say it is a CBO forecast. Is that the same as CBO numbers, or is that just their basic assumptions?

Ms. TYSON. That is basically using their assumptions about how the economy interest rates——

Mr. ARCHER. So those are the basic assumptions?

Ms. TYSON. Basic assumptions.

Mr. ARCHER. The President when he spoke to the Congress—and he got large applause—said we were going to be honest in our budget. We are going to use CBO numbers. He did not say assumptions. He said CBO numbers. And I believe based on the latest CBO numbers that are now at our disposal, that those Presidential deficit figures are completely wrong.

Ms. TYSON. Actually that is not true, although using CBO numbers, one gets different amounts of deficit reduction. Using CBO numbers in fact brings you to a deficit relative to GDP level in 1997, with our spending and revenue programs as estimated by CBO, actually brings you to a 2.7 deficit to GDP ratio.

So while it is true that CBO has now estimated what they believe to be the spending cuts and revenue increases from our own program, they end up in the same deficit-to-GDP place that we do.

Mr. ARCHER. But the deficit numbers are very different——

Ms. TYSON. By the outyear——

Mr. ARCHER [continuing]. Than what came out of OMB and Treasury.

Ms. TYSON. It depends on what you mean by deficit numbers.

Mr. ARCHER. The total amount of the deficit, they said there was a shortfall and that is why you are going back to pick up another $55 or $63 billion of spending cuts. The cuts are not there, but I don't want to belabor this because time is fleeting.

You mentioned a very interesting thing to me. You said we should have more and more Government investment because that creates economic growth. Yet the Europeans are telling us that all of the increased government investment that you compare this country to, has dragged down their economy. As a result, that they are moving away from government investment and letting, as the chairman said, the private sector have a bigger and bigger role.

I just want to make that point. But you also said that we don't tax energy enough. You compared the taxation of other countries in the world of energy to ours.

I would like for you to cite me one country in the world that taxes its basic raw energy at all. I am not talking about gasoline taxes or diesel fuel taxes or jet fuel taxes, which are consumption taxes. I am talking about the raw ingredient that applies itself through the industrial capacity of a nation. Can you tell me one other country that taxes its basic raw energy?

Ms. TYSON. Let me first answer or address your first point.

Mr. ARCHER. No, I would like for you to answer my question.

Ms. TYSON. The answer on your second point is that basically the incidence of this tax will filter through all uses of energy in the system. I have——

Mr. ARCHER. With all due respect, can you answer my question? Is there——

Ms. TYSON. The answer to your question—the answer to your question is, I do not know, first.

The second answer to your question is that it implies something which is not true, which is that this energy tax will be paid by pro-

ducers at the point of production. This kind of tax will filter through the system on all end uses of energy and consumers will pay the tax; industrial producers who use energy will pay the tax.

This is how this tax will work. It is a tax on an input which is reflected on the cost of that input to users of that input, and to products which embody that input in production.

Therefore, the incidence of the tax will finally go to consumers of energy.

Mr. ARCHER. How can you be sure that it will not be disadvantageous to job growth since no other country has done this? You have no model to compare it to?

I would cite you specifically that in the petrochemical industry, which depends upon energy for more of the cost of its product than any other factor, it cannot pass that on in the world marketplace. It is the single largest producer of exports for this country, over $44 billion last year, netting out a $16 billion trade surplus for this country. They cannot pass that on in the world marketplace.

You say it is just going to be passed on. It will mean a shutdown of the petrochemical industry.

Ms. TYSON. The first thing I would say is, we do have a way of thinking about the effect of such a tax, and we have looked at this in terms of models. It is quite easy to model the effect of such a tax. This is a very small tax. And if you model its effect on aggregate levels of output in the United States or the aggregate price level, you see very small effects, less than a quarter of a percentage point.

In addition, I want to emphasize right away that this part of the package, if you look at the effects of the tax in isolation you might say it raises business costs. On the other hand, if you look at the tax along with a dramatic decline in long-term real interest rates, the net effect is business costs with other tax incentives can be quite a bit lower.

So to look at a single tax, which we did model the effects of, at this rate, the Btu rate we are proposing, is a very small aggregate effect on either output or the price level.

Mr. ARCHER. Well, Dr. Tyson, it is not every industry that has high energy prices that it has to filter through its production process. The steel industry, the aluminum industry, the glass industry, and many others. It is an immediate tax on their product that they will not be able to pass on in the world marketplace because no other country in the world taxes its raw energy. That is the problem.

And then the domestic market for the very same companies will be infiltrated by foreign products that use large amounts of energy. It will destroy the domestic market for our internal producers who cannot pass it on, and let it flow to the marketplace.

You will then probably decide that we have got to have a tariff czar that will determine how much energy is in each incoming manufactured product and assign a duty to that product as it enters this country in order to protect the marketplace for our domestic producers. That is an absolute disaster for this country.

My time is up. The Chairman is banging the gavel here. But I thank you very much.

Chairman ROSTENKOWSKI. Mr. Levin.

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Mr. LEVIN. Just to put the last argument in perspective, what is the gasoline tax in European countries compared to the United States?

Ms. TYSON. It is anywhere from $2 to $4 a gallon more.

Mr. LEVIN. And what is our present reliance on imported oil?

Ms. TYSON. I think we have about 40 percent. It varies from time to time, but 30 to 40 percent.

Mr. LEVIN. So I really think when one looks at the issue of the Btu tax, one needs to look at the overall taxation of energy in countries.

Let me ask you to shift just a bit to manufacturing and the impact of this program on manufacturing. The President last year talked intently and intensively about the importance of the manufacturing sector and a rekindling within it. What would be the impact basically of this overall program in your judgment on the manufacturing base of this country?

Ms. TYSON. I would hope that—I would anticipate that the package, each part of the package can add to the health of the manufacturing sector, the stimulus part of the package by increasing spending in the U.S. economy.

Part of the problem of the American manufacturing sector is simply a slow economy, and a slow economy is slow demand for all output, including all manufacturing. So part of the effect is simply through increasing demand.

Part of the effect is indeed through an investment tax credit approach which very much focuses on equipment. Equipment is produced in the United States. We have a real comparative advantage compared to many other nations in the production of equipment used in manufacturing, used in industry. So I think the investment tax credit approach will help manufacturing.

I think our education and training package is meant very much, particularly the training part of the package, to try to deal with, for example, our weakness in educating the non-college-bound children who do not enter the work force with high enough skill or education level, and helping with that transition period so that manufacturing companies might be encouraged to stay in the United States and foreign manufacturing companies might be encouraged to come here.

I think the civilian technology part of our program is extremely important to manufacturing, both in terms of helping the manufacturing industries in the United States develop new technologies and encouraging their diffusion.

Finally, let me emphasize once again that we are going to help all segments of this society, including manufacturing industries, by really putting us on a course of sustained, lower long-term interest rates, which are important both as a component of capital costs for manufacturing but also as a component of capital costs for people buying homes. So it will help any user of long-term capital in this country.

Mr. LEVIN. Very good. You have mentioned in your statement about the increase in jobs. Do you remember as I do, I think correctly, that while there was an increase in jobs in the last reporting period overall, that was not true basically for manufacturing?

Ms. TYSON. Yes, that is true.

Mr. LEVIN. I want to then express again as I did earlier, I think it is important as we try to improve the climate for manufacturing in this country through economic policy, we don't run in the opposite direction in trade policy.

Investment, as you so graphically described, has been paltry in this country. And I think as we look at your trade policy, we have to be sure that we stimulate investment here, because so critical is going to be investment decisions in the next years in terms of jobs here.

Thanks so much for your testimony.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Dr. Tyson, I agree with you that we need to take a look at the total package and what impact the total package will have on our economy and what we are trying to accomplish by increased productivity, new job opportunities, higher wages for Americans. But I would like to focus for a moment, if I might, on the stimulus package, the short-term stimulus package that the President has recommended, and part of which will surely be on the Floor for our consideration.

There have been those who argued that at the time we are trying to reduce the Federal deficit, it is inconsistent to also look at more spending at the same time. You made a very strong point about the need to reduce the Federal deficit and the impact it is having on the available capital for private sector investment. But then we are taking some of that available deficit reduction and now using it for spending.

You mentioned at the end of your opening remarks that part of the package is there to make it passable. Is the short-term stimulus package really needed for our economy, or is it part of a political equation in order to get the support necessary for this package to pass?

Ms. TYSON. Actually my "passable" comment was a list of criteria of what went into the deficit reduction part of the package, that is, trying to figure out, for example, issues of regional balance or program balance. That we were looking for a package which was sufficiently balanced, sufficiently credible, large, that it would in fact be one that the American people would support and it would be passed. So I was using that word with regard to the deficit reduction part.

As far as the stimulus package is concerned, I guess I have two things to say. One is that deficit reduction is good for the country in the long run. No doubt about it. It is good for the country because it is going to help us bring more capital at lower rates to the private sector.

Deficit reduction also by its nature means either increasing revenues as increasing the burden of revenues on the economy or taking spending out of the economy. When the economy is weak, as it is right now, when you are far under capacity, as we are right now, we run the risk of taking a recovery which has stalled out before and actually really stalling it out by either imposing a new tax burden on the economy or taking a major amount of spending out of the economy.

I like to figure it as a situation in which we are making the economy healthier so we can then get it on a course of deficit reduction. Getting it healthier means giving it a boost to get to its old capacity momentum, and then as we reduce the deficit, we can do it in such a way as to not undermine the growth of the economy. That would be my first point.

My second point would simply be that when the economy is weak the way it is, the deficit is actually of course larger than it would be if we had a healthier economy. So to some extent, not completely, but to some extent the stimulus package by bringing us closer to capacity output will have some deficit reduction effect itself. That is, the net effect on the deficit will not be the $30 million, it will be less because of growth in the economy caused by the stimulus. And we have estimated it will be something on the order of $8 to $10 billion less as a result of growth in the economy caused by the stimulus.

Mr. CARDIN. So the stimulus package, in your view, as part of this overall package, is needed for the recovery of our economy; it is not being put into the equation because of the political mix?

Ms. TYSON. From my point of view I would say there is a very powerful economic argument, and that is the argument that I—that is the reason for my supporting the stimulus.

This is an economy which if you look at its state, if you look at the past months of prolonged slow recovery, if you look at the extent of underutilization of capacity, there is a very powerful economic argument for this.

Mr. CARDIN. One quick question before my time expires. The Budget Committee now looks like it is going to be recommending an additional $55 billion in cuts. I take it from your presentation that that is consistent with the final figures you were trying to reach in 1997, and is consistent with the message that you believe is important in the economic package?

Ms. TYSON. Yes. Let me just say something about those numbers once again. The numbers issue here is using our spending program and our revenue program, CBO estimated that we were not going to get the same amount of deficit reduction as we anticipated.

Now, both their numbers and our numbers, and all budget numbers projected out to 1997, are subject to change and to rather considerable change. But given that, my understanding is that the House Budget Committee is proposing these additional cuts to try to get us, relative to CBO numbers, rather than CBO assumptions, to approximately the same amount of deficit reduction that we requested.

Assuming that all of these preliminary numbers turn out to be correct, then it is absolutely consistent with what we are after.

Mr. CARDIN. Thank you, Doctor.

Chairman ROSTENKOWSKI. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Dr. Tyson, nice to see you. As I mentioned to Mr. Panetta earlier, I want to thank you and your associates for what you are doing to reduce the budget deficit and to also reorient the economy toward a greater emphasis on investment and less on consumption.

You have talked about more capital at lower rates to the private sector. That gets involved in productivity and that gets involved in other investments.

I have got two questions for you. One is a little bit of a tough one; you may not want to answer it. I don't know how much time we have. Very specifically, it gets toward investment and spending. I have the proposals here. The Lord giveth and the Lord taketh away. What happens is you have a tax increase which sucks out money from the system, reduces savings, reduces spending, therefore reduces employment. You have military reductions which in turn reduce the employment of the military, and which, again, increases unemployment. Then on the other hand, in order to offset that, you have tax incentives for a variety of different businesses, particularly the high-tech businesses on the west coast, and also you have spending programs.

Why don't you just leave it alone so you don't offset one problem with another which you create when you increase the taxes and reduce the military?

Ms. TYSON. Let me say that the deficit reduction part of the package, which is basically the increase in taxes and the reduction in spending programs, not just defense but other programs, the primary purpose of that is to reduce the Government's claims on the economy in terms of borrowing money, driving up long-term interest rates. That increases private investment.

At the same time we are doing that, we are increasing public investment, another kind of investment in our society, which we believe also contributes to future prosperity.

On a net basis, when you net all that out, we are reducing government spending compared to output in the economy, and we are reducing the deficit compared to output in the economy, while at the same time we are changing the composition of Government spending away from consumption-type expenditures and to investment-type expenditures.

So we are not trying to take away and give back equal amounts here. We are really reducing the size of the Government, reducing the deficit, reducing the claim of the Government on society's resources, at the same time that we are shifting what the Government does to more future-oriented investment activities.

Mr. HOUGHTON. Yes, but, Doctor, if one of the critical issues of investment is not investment for itself but for the increase in productivity, then realize that productivity comes from the private sector, not really the Federal sector. Therefore, why not let the private sector do its own thing without sort of offsetting one evil with another good?

Ms. TYSON. First of all, I would argue that both the public and the private sector contribute to productivity. It is not simply the private sector.

I actually disagree with the comment made earlier that public investment in Europe is now being looked at by the Europeans with concern. Public investment is not all public spending. It is not only state enterprises. Public investment, as we are using it here, is basically investment in the foundations of a modern economy. It is investment in infrastructure. It is investment in civilian technological information. It is investment in education and skills for the

work force. The private sector needs those kinds of public investments to complement what it does.

Let me just take infrastructure investment for a minute. The CBO—again, we can use the CBO as, I think, an objective source of information—has analyzed a number of studies on infrastructure, of spending projects by the Government, and has concluded that they have very high rates of return. They help, they do as well in rates of return as private sector investment.

Further, a number of studies have shown that private sector investment is encouraged by public sector investment. That is, if you build a more modern airport or you build a more effective highway system, you encourage private investors to do more investing. So I don't see it as either/or. I see certain kinds of public investment as contributing to productivity.

Mr. HOUGHTON. I understand what you are saying. I think I agree with it. The problem is that is $8 billion out of a total of $160 billion. So, you know, the infrastructure argument doesn't flow through all these other things.

Look, I am running out of time, and I want to ask you one other question. Have I got a minute more? You look askance at me.

Chairman ROSTENKOWSKI. One minute.

Mr. HOUGHTON. The question is, as you tackle a deficit, how much time have we got? You may not want to answer this, but I am going to ask it anyway. Mexico thought it had a lot of time. It didn't. New York City was able to sell its short bonds for 200 years. It ran out of time.

How much time do you think we have before the chickens come home to roost, and our being able to float our bonds outside this country?

Ms. TYSON. I think that I am very gratified by the response of the domestic and the international capital markets to the deficit reduction package that we have proposed. What the interest rates are telling us, what the stock market is telling us, what global reaction to our plan is telling us is that there is a critical, balanced approach to deficit reduction which will restore the credibility of the U.S. Government to both negotiate internationally but also to borrow abroad.

We are going to be able to borrow at lower interest rates, and that is because people look for it over that 4-year period and see substantial progress being made.

Now, as to about how much time we have to get rid of the deficit, to try to get the deficit close to zero, we spent 12 years getting it up to where it is. I suggest that we think about a decade-long approach of reducing the deficit relative to GDP ratio in half in the next 4 years. Then we will be trying to do something comparable in the 4 years after that, which we hope to work with you on in terms of a beginning to our health care proposal. So I think we should have a long-term agenda for that problem.

Chairman ROSTENKOWSKI. Mr. Cardin will inquire.

Mr. CARDIN. Mr. Chairman, I have already inquired. Thank you.

Chairman ROSTENKOWSKI. Mr. McNulty. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and welcome, Dr. Tyson. Thank you for being here. I first would like to applaud President Clinton, applaud you and the administration for what I

think is a very bold and visionary economic plan and one that I intend to support very fully, and I look forward to working with the administration as we define and implement some of these additional spending reductions that we have talked about in order to get to the OMB numbers.

I had asked earlier today when Leon Panetta was here a question, and he suggested I should ask you this question, so this is that question. I think it really gets at what a lot of people on both sides of the aisle seem to be interested in here. It has to do with the competing objectives of generating economic growth through stimulus, economic stimulus and through investment and the competing objective of reducing the deficit.

It seems to me that what we will need to look at as we consider the reconciliation on this committee is the impact on the private sector and on businesses in particular of these competing proposals. For instance, to our businesses we are talking about higher corporate taxes for those who generate more than $10 million in profits. We are talking about a Btu tax, on the other side we are looking at investment tax credits, we are looking at for small businesses some capital gains tax reductions, and then very importantly we are looking at as a result of the deficit reduction or the anticipation of that lower interest rate, so my question is what kind of analysis has been accomplished which looks comprehensively at the policies as they relate to the private sector and business to determine what job growth will be most likely as a result of all of these policies as they cumulatively apply to the private sector?

Ms. TYSON. Well, we started, we have already done some analyses at the macro level trying to look at the effects of all of this package together, interacting, the parts interacting over the next 4 or 5 years. What we have come up with again, and it is a cautious estimate, I would say, is actually in the "Vision of Change" document.

We did essentially an administration policy forecast for growth of the economy over the next—really the forecast runs from 1993 through 1997—and we did the forecast using traditional models of the economy, putting into those models all the elements of our package, and what we came up with was an economy which can indeed grow through this process.

Our growth rates are actually higher than the—once we incorporate our policy into these projections, we end up with higher growth rates than, in fact, the CBO economic assumptions suggest. This comes about in part because of our investment tax credit, in part because of our investment spending, in part because of our lower long-term real interest rates, so that we have already done the macro analysis is the first answer to you, and if you look at our growth rates, we have the economy growing with administration policy at the rates of 3.1 percent in 1993, 3.3 percent in 1994, 2.7 percent in 1995, 2.5 percent in 1996, 2.5 percent in 1997. Those are conservative estimates. We did not give ourselves credit in these analyses for the kind of interest rate correction we have already seen.

In fact, that has been a surprise to everyone, that we would get—and I don't mean just everyone in the administration, but I

think it has been a surprise to the capital markets themselves to get such a big effect early on will be extremely helpful to us to grow through this process because rather than wait for the long-term rate to come down 3 years out, we actually are benefiting from a long term rate decline right up front, so the rates of growth I gave you actually I believe to be on the conservative side.

The unemployment rate then with the rates that I gave you comes down gradually from 6.9 percent—an estimate of 6.9 percent in 1993—down to 5.9 percent in 1996. So we have the economy on a growing trend throughout this period. Now what we are doing is we are now trying to look at the effects of the package on individual sectors of the economy. We just have started that process.

This was a macroeconomic exercise to look at the effects on the overall economy. We are now, for example, looking at, trying to look at, and piece together what we anticipate to be the effects on the large scale manufacturing industries or small scale businesses and manufacturing. Our estimate so far suggests again when you net in everything here, you include the investment tax credits, you include the enterprise tax credit, you include the research and expenditure tax credit, you include lower interest rate effects that we believe this will be a beneficial package to American manufacturing, for example, so we are looking at those kinds of questions.

Mr. PAYNE. One quick question. If you determine in those micro exercises you are doing now there are segments of the economy that are negatively affected, do you anticipate to offer public policy that would correct that?

Ms. TYSON. I think so far we have been pleased by what we have seen, but if we were to discover any significant imbalances in the package that would be an issue of concern for us because one of the things we were trying to do is to come up with a balanced approach, so if we find that there really are significant sectoral differences, that would be something we would look at carefully.

Mr. PAYNE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman. Welcome, Dr. Tyson. I would like to congratulate you on the addition of professor Joseph Stiglitz to the Council as well. There has been a lot of discussion over the last year, through the campaign and into this year about the making of an industrial policy for our country.

In fact, The Washington Post this last Sunday had an article on this. President Clinton, Vice President Gore have outlined a broad plan to steer $17 billion in tax breaks in Government spending into high technology products, and there has been a proposal for an information super highway to foster the free exchange of information.

What is your evaluation of the economic wisdom of such an industrial policy and how do you avoid some of the pitfalls that other countries have experienced with doing such as that?

Ms. TYSON. I would like to think of the civilian technology part of the package as basically a reconfiguration of what has been a massive effort in this country to support technology in the past through the auspices of the Defense Department. That is, if you look at the United States during the postwar period, we have had tremendously healthy and vibrant high technology sectors.

If you look back into their birth, if you look back into the times when they were young and developing, you will see tremendous amounts of research and development support, procurement support, training of skilled engineers and scientist support, all of that going into the American economy under the rubric of national security and defense.

Now as we change the weight of our concerns, as we scale back somewhat our geopolitical concerns and military concerns and look to our economic concerns, I would suggest we need to come up with a new set of policies and institutions to continue to sustain the vibrance of American science and technology, and that is what I see this program as designed to do. So it is not really a change in the importance of technology policy to the American government so much as a change in how it is delivered.

Mr. KOPETSKI. OK. Let's shift over to the credit crunch. As you may recall at the economic summit there was a lot of talk about bank regulation and the problems and the effect that it was having on banks lending money. It is my understanding that both the legislative and regulatory package would be needed to accomplish these kinds of reforms.

Do you expect that the administration—do they plan to pursue a legislative and administrative action to stimulate bank lending?

Ms. TYSON. I believe there is going to be a statement on that by the President sometime this week, and I also would say that the administration is both interested in issues that might deal with shortrun problems of access to credit and capital, particularly for small and medium-sized companies, but there is also a longrun problem, that is even when the economy is strong it is more difficult for small and medium-sized companies to get access to capital than it is for larger concerns, so we need to think about this as a problem again of policy or institutional change to look at even in the long run, so the administration will be looking at that both as a question of what can we do immediately and what can we do over time.

The second thing I want to say is that again if you look historically at differences in the cost of capital between the United States and the rest of the world, you will see that through the 1980s we had a much higher cost of capital than other countries. The most dramatic thing this administration will do, I think, in that area is simply to bring long-term real interest rates down to a much different level for a sustained period of time.

Mr. KOPETSKI. Let me shift over to the enterprise zone issue that came before this committee last time, and I hope will be before us again. What are your thoughts or what is the administration's current thinking on these in terms of urban, rural, and Indian lands and then the problems we had in the Northwest with timber communities which tend to be the small town with a single mill or maybe two mills, but they are in a county with a large city, and so there is a different kind of problem that we have with those.

Ms. TYSON. I see. We are interested in having the enterprise zone concept defined broadly enough so we can include rural areas, Indian reservations and urban areas. I believe we have made a tentative proposal of 15, 10, and 5 split, 15 urban, 10 rural, 5 Indian reservation.

But I think there is a notion of wanting to be flexible here in a sense of trying to figure out a way to use these zones in areas or to use low-interest loans even in areas which are not specified, specifically designated as zones, but to use some of the benefits that would be associated with being a zone for other regions or areas where we believe some extra help might be needed for development purposes.

Mr. KOPETSKI. I would hope that we could tie into some of these enterprise zones some of the actions that you want to take with respect to industrial policy and telecommunications, highways, et cetera, so we can draw those very kind of things into those areas, whether it is the difficult areas of Los Angeles or some of the mill towns in Oregon.

We can do that today with the technologies that we have, the faxes and modems and communication networks.

Ms. TYSON. Right, I agree.

Mr. KOPETSKI. Thank you very much. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Dr. Tyson, explain to me how the administration figures the Btu tax will decrease reliance on foreign oil or imported oil. Would you explain that to me?

Ms. TYSON. Yes, there are two approaches to this. One is in general a tax like this will discourage all forms of energy use. Yes, the Btu tax is adjusted to tax petroleum-based fuels at a higher rate than other forms of energy. The general effect of the Btu tax is to discourage all forms of energy use. The higher rate on petroleum products in particular will discourage the use of fuels derived from oil, including from imported oil.

Mr. MCCRERY. Do you know that it generally costs more to produce oil in this country than it does in many other countries, particularly in the Middle East?

Ms. TYSON. Yes, I do know that.

Mr. MCCRERY. Well, if you reduce demand, therefore squeezing out the need for some of the supply, doesn't it make sense that the first oil to be squeezed out will be the high-cost oil that cannot absorb the cost of the tax increase?

Ms. TYSON. Yes, but because all oil is sold in the United States for the same price, any reduction in demand for oil will reduce both imported and domestically produced oil. While some marginal domestic production will no longer be profitable to produce, the reduction in the demand for oil will also reduce the importation of oil.

And while the plan is reducing overall energy use, it particularly reduces the use of oil, resulting in declines of imported oil relative to other sources of energy.

You have to sort of think about it as reducing overall energy consumption at the same time that you twist energy consumption away from imported oil.

Mr. MCCRERY. But while that may be true, the bottom line is you are going to reduce the amount of oil that is produced domestically.

Ms. TYSON. The bottom line is that this tax in and of itself would discourage the use of oil, discourage the use of domestic oil and discourage the use of domestic production of oil, that is right. But again, in my answer I want to emphasize that this is part of an

overall plan to reduce energy use, to reduce pollution, and part of a broader effort of deficit reduction.

It is not that we are proposing a Btu tax because what we want to do is discourage the domestic production of oil. We are introducing a Btu tax as part of a very bold package to reduce the deficit. If we reduce the deficit and get interest rates down and get the economy on a longrun course of prosperity, then you need to take into account the beneficial effects on the domestic oil industry and all other parts of the domestic economy from doing that.

I think it is very important to weigh the benefits to the economy in all sectors of the economy against the cost of what happens to any particular—from looking at any particular component of the package.

Mr. MCCRERY. Well, you have actually given two reasons for the higher tax on oil in your package. One is to lessen our dependence on foreign oil. We have gone through that. I am still not sure about that. It seems to me that you are in fact going to just lessen reliance on oil and that the losers will be our domestic producers, but leaving that aside, your second reason was that you want to encourage a source that is less polluting than oil.

Well, if that is true, then why do you favor coal in your proposal? Why is the tax on coal not doubled?

Ms. TYSON. I think you should think about the way we structure this vis-a-vis alternatives. That is if you just were—we were looking for a tax that was relatively balanced, the way we structured this tax it actually will work if you sort of look at the substitution effect between energy.

First of all, let me say the overall effect is that it will reduce energy consumption, it is not a big tax and it is not a big effect but the effect of reducing energy consumption or encouraging energy conservation is something which I think can be defended as a goal on its own.

Then in terms of substituting among energy sources, in fact the tax works to encourage gas over both oil and coal. Natural gas is, as an energy source if you are thinking about pollution issues, the preferable energy source from that point of view. So this tax both discourages overall energy consumption and twists patterns, although in quite a small way, in quite a modest way towards natural gas, and that was what we had in mind.

Mr. MCCRERY. Finally, you say in your testimony that the 1997 Btu tax raises $22.3 billion after netting out roughly $7 billion in reduced income and payroll tax receipts. What is the explanation for netting out $7 billion in payroll and tax receipts?

Ms. TYSON. That is a standard approach that the Treasury uses whenever it estimates the revenue effects of any excise tax. This could be an excise tax on energy, it could be an excise tax on cigarettes, a sales tax. Basically the argument is that a tax, an excise tax, a sales tax basically by itself, so again it is a very partial analysis, by itself takes—reduces incomes, and therefore those reduced incomes result in lower tax revenues because incomes are reduced.

That is a very partial analysis because in our whole model and given our whole macroeconomic assumptions, the economy actually does not have a reduction in income as a result of the Btu tax and everything else, it actually grows right through it with increased

incomes and increased tax receipts as a result of its growth, so that is a particular Treasury estimating convention which asks the effect if there was no growth in the economy and you increased taxation of something, in order to pay that additional tax the economy would end up having reduced income and reducing taxes on other things, so it is an estimating convention.

Mr. McCRERY. Thank you.

Chairman ROSTENKOWSKI. Mr. Reynolds will inquire.

Mr. REYNOLDS. Thank you, Mr. Chairman. Welcome, and congratulations and all of that.

Ms. TYSON. Thank you.

Mr. REYNOLDS. I welcome your input today. I was a little confused, however, from some of the things you said regarding the enterprise zones. In your testimony you mentioned enterprise zones as being 30 zones, you have mentioned that, and then in your written statement you talk about 50 enterprise zones.

Ms. TYSON. Well, we can look it up. It is my recollection there are 30, not 50.

Mr. REYNOLDS. Fifty, on page 5 of your testimony——

Ms. TYSON. It is certainly possible that——

Mr. REYNOLDS. Next to the last paragraph.

Ms. TYSON. We have a staff back here to find out the real number. In the meantime we can talk about the actual——

Mr. REYNOLDS. My question—first of all, that is important to know.

Ms. TYSON. Yes, we can find it out, it is in the document.

Mr. REYNOLDS. My question——

Mr. RANGEL. If the gentleman would yield, I was with the Secretary of HUD this morning, he told me there were 10, so if that makes any contribution to it.

Ms. TYSON. Well, we have the printed word.

Chairman ROSTENKOWSKI. The decision hasn't even been made yet, has it?

Ms. TYSON. The Chairman asked if we would negotiate on something, I guess we are going to negotiate about this number, that is one of the things we will negotiate about.

Mr. REYNOLDS. Just trying to get a little consistency.

Ms. TYSON. I think that is only fair.

Mr. REYNOLDS. Something to work from.

Ms. TYSON. I agree.

Mr. REYNOLDS. The zones, I know this is early on about the enterprise zones, including the enterprise zones into this discussion is something that I am very happy about. Has there been much thought, though, in the administration about how these zones are going to be determined other than 25 or whatever urban and 25 rural and who is going to—how does it work?

Have we thought about that at all or is that somewhere we can look up?

Ms. TYSON. In fact I would have to say that so far I have not been in discussions about that. That does not mean that such discussions have not occurred, but I would have to say this generally our approach to the enterprise zone question was to say what would we include in tax incentives for the zones, how many in aggregate did we think relative to all of our other competing demands

and deficit reduction constraints and revenue constraints we could afford. We had the Treasury estimate out the effects of those tax incentive packages at alternative numbers, probably part of the reason for the alternative numbers here is we were estimating effects of various numbers of packages, but then the criteria that would finally be used to determine where they would be located was not discussed.

We did make a preliminary determination of a rough breakdown between urban, rural, and Indian reservations, but we did not go into further criteria.

Mr. REYNOLDS. Thank you. Let me just ask a followup question. As you know in some areas of the country the unemployment is chronic and we are looking at a 7-percent unemployment rate in some areas, in my district that would be a great improvement if it was only 7 percent. People have looked at it from that perspective.

What are your projections as to how many long-term jobs are going to be created by this package?

Ms. TYSON. By the entire package?

Mr. REYNOLDS. Yes.

Ms. TYSON. We have made some runs on that at the macroeconomic level which suggest that we can achieve over the next 4 years, we can reach, and I believe exceed the 8 million job promise made in the campaign. Some estimates, some macromodel runs give us estimates that are significantly higher, in the 9 million range.

It is important—I mean, again, this is an issue of trying to get the balance right, trying to do enough deficit reduction to be credible but not so much in any given year as to really undermine the growth capability of the economy, and we were very cautious about this when we put the package together, and then we were running these models to see, well, can we get the job growth that we really are committed to wanting over this period, and we believe that we can do that.

Mr. REYNOLDS. Thank you very much.

Ms. TYSON. When we find the enterprise zone number, you will be the first to know.

Chairman ROSTENKOWSKI. Mr. Jacobs will inquire.

Mr. JACOBS. As I understand it, the plan of the administration is everybody will make some contribution. Is that right?

Ms. TYSON. The plan of the administration is to try to develop a package which asks broad-based contributions across a wide category of spending areas, of regions, of sectors of the economy. It is an attempt to be a balanced package.

Mr. JACOBS. Right, and as an economist I am sure you realize that time is money and so my contribution is my 5 minutes. I yield it back.

Chairman ROSTENKOWSKI. Mr. Santorum.

Mr. SANTORUM. Thank you, Mr. Chairman. I am the Ranking Member on the Human Resources Subcommittee, and we had a lengthy debate last week and the week before on unemployment compensation extension. I said during that debate, and I think it bears repeating that we need to focus in on investment, and we also have to reduce the deficit.

That sounds great, and it is a great message to take to the American public, but the first thing we did was to extend unemployment benefits, and thereby increase the deficit $5.7 billion. That was consumption spending, clearly consumption spending, not investment spending. Yet we see the arguments made that we need this temporary fix and then enact your long-term program to really increase employment. We have a jobless problem here, and we have a jobless increase in our economy. Yet when I look at your own administration's figures the unemployment rate will only fall from 5.8 percent to 5.7 percent in 1997 due to your proposal.

Now, I cannot understand you are making claim that we are going to do great things with this package. As a part of that package though, we first need to take care of the unemployed and we need to spend more money and consume it and increase the deficit. I don't see either benefits. I don't see the benefits in the short run by doing what we just did nor from your own numbers do I see the benefits in the long run of taxes, increasing spending, doing very little about reducing waste in Government and still not significantly lower unemployment.

Ms. TYSON. OK. Let me say something about deficit reduction and the unemployment rate. Deficit reduction itself, as I indicated in my comments, tends to be—its impact immediately is to tend to make the economy grow more slowly because you are either increasing taxes or taking spending out of the economy.

However, what you get for that, for the unemployment rate going down but not going down much more rapidly than it would have anyway is an increase in productivity and higher wages. I talked about my investment as an investment——

Mr. SANTORUM. If I could interrupt for just a second. You admit, then, that this package of growth stimulus, et cetera, is not going to cause very significant gains in employment?

Ms. TYSON. We have to make a distinction here between stimulus. I really——

Mr. SANTORUM. Your package will not make very much difference in employment over the long run.

Ms. TYSON. No, I think that our package will, number one, in the stimulus part of the package, which is the part you started with initially, will actually over the next 2 fiscal years add 500,000 jobs to the economy.

Mr. SANTORUM. Short-term jobs.

Ms. TYSON. Over and above—it is not short-term jobs. Those are jobs that will be added to the economy giving us time to get back to capacity and then we are on a trajectory of growth from there on.

Mr. SANTORUM. But those jobs—you just answered that, are short-term jobs.

Ms. TYSON. No, they are not short-term jobs. They are jobs. They are jobs created through additional demand in the economy. The additional demand—look, here is how—let me tell this story——

Mr. SANTORUM. Additional demand created by what?

Ms. TYSON. I will now tell you the story. You give someone—you give a company an investment tax credit. They buy a machine. The firm producing that machine hires a worker, the worker who pro-

duces that machine has an income rather than no income. They, in turn, consume things. They, in turn——

Mr. SANTORUM. My time is short. I understand the multiplier effect. I understand that. But the point that was made by the chairman, and I think well made, is that you may be just accelerating investment decisions as opposed to really creating anything new. That is playing with the Tax Code for a questionable result.

Ms. TYSON. We are accelerating investment decisions in the short run and we are encouraging them in the long run through our long-term investment credits and through lower interest rates, so we are doing two things.

Mr. SANTORUM. The second point you made in defense of the need for a stimulus package is actually the same as the first one, because you don't want to cut Government as it could hurt the economy. You assume, then, that there is no waste in Government.

Ms. TYSON. I am not proposing for us to increase waste in government.

Mr. SANTORUM. That wasn't my point. You assume by that statement that there are no cuts that can be made in Government that are wasteful, that eliminates waste, and therefore by eliminating waste, actually creates efficiency in Government and actually creates more resources in the private sector. Your argument is that we shouldn't go after cutting additional Government spending programs at this time is that we would hurt the economy by doing so.

Ms. TYSON. Can I respond? What I would say is I would love to go after waste in Government at any time, and I think this administration stands ready and is actively ferreting it out in the agencies that it controls right now, would be happy to do it at any time.

If we found instantly $10 billion of waste in Government that we could rid ourselves of this year, I would propose putting it into $10 billion of investment spending by the Government or $10 billion of additional investment tax breaks by the Government to get the economy moving through its recovery faster, so I would love to shift Government spending from waste to more productive forms.

Mr. SANTORUM. My time is up. Thank you.

Chairman ROSTENKOWSKI. Mr. Matsui.

Mr. MATSUI. Thank you very much, Mr. Chairman. I would like to thank Dr. Tyson for her testimony and for all the work that she and others in the new administration have put into this economic package. I find it ironic that some Members on the other side of the aisle would talk about getting rid of waste. After all, this administration has been in office now less than 2 months, but the prior two administrations had 12 years. How ironic that waste becomes a very major significant issue for the other side of the aisle.

I think the economic package is extremely balanced, it is one that all of us have an obligation to support, and frankly I am looking forward to the votes on the Floor of the House sometime in July when we will find out if Members are sincere about their belief that the Federal budget deficit should be, in fact, reduced.

I am sure the other side of the aisle will come up with thousands of reasons why they can't vote for this package. We already heard one excuse when one gentleman talked about the energy tax and how that would devastate the economy of the United States. To state that raising $71 billion over a 5-year period would have that

kind of impact is nonsense. Mr. Levin raised also the interesting fact that the Europeans and the Japanese pay over $2.50, $3 as you indicated, for the cost of their gasoline while we have a relatively low price ourselves. I would like to ask you one question, however, on the capital gains provision with respect to venture capital.

The administration's package sets a $25 million cap for qualifying venture capital companies. Many of the emerging companies, such as biotech companies, which are basically capital intensive rather than labor intensive, will have a difficult time fitting within that cap. That is why when Senator Bumpers and I introduced the bill that I believe your legislation is patterned after, we included a $100 million cap.

It is my hope that you and the administration will be able to look at lifting that cap from $25 million to $100 million or somewhere in that range so that more small companies will be benefited by this capital investment incentive. If you can respond now or later or perhaps you are in the process of——

Ms. TYSON. I would be happy to talk with you about it, and we had had some talks with representatives of the venture community on this issue. This is again an issue of balance here. We are looking for a tax approach which primarily will recognize the importance of small startups to job creation in the United States, and as you move that size cap up from $25 million to $100 million, you are running much closer to basically bringing the entire set of American enterprises, small or large, into this targeted tax capital gains relief program, so we were looking for a way to really focus on small startups, and that is how we came to that figure, but I think that there is room to sort of discuss what the right cap should be, both to get at the small scale incentive that we want but at the same time to really have a real effect on sectors that are important to growth.

Mr. MATSUI. I appreciate that because maybe the $100 million might not be appropriate and we can find some area where we don't pick up companies that don't really deserve the differential but include companies that certainly would take advantage of it for job creation and other purposes.

One additional comment concerns the 12 percent capital gains differential currently included in the economic package. To recap, I don't know if it was by happenstance or if it was by design, and I am sure you are aware of this, but in raising the effective rates for individuals from the current 34 percent rate, with the additional 10 percent surtax, to the 40 percent rate—including the increase in the rates and the phaseout of the personal exemptions and itemized deductions, we created a 12 percent capital gains differential for those above the 28 percent rate. If the rates were only increased to 34 percent, the differential might not have been a problem, but a 12 percent differential is a different story.

If in fact we should expand the passive losses more than what you have proposed in your package, to the point where it was under the original Andrews legislation, that could create a substantial tax shelter problem. In fact, we have been hearing on K Street that this would be a significant problem.

In addition, I expect that, with a substantial differential, some corporate entities would accumulate dividends rather than pass them out because it would be better for the stock to be exchanged at the capital gains rate.

I am wondering how much thought has been given to this? Was this 12 percent differential done by design or is it something that should be looked at? I know that Senator Bradley has a problem with this. I am beginning to think that if we allow this to happen, we are going to have to make other changes in the Tax Code that are not part of your package, and it could really add complexity to our deliberations.

I would hope to ask Senator Bentsen this tomorrow and perhaps you could respond to it as well.

Ms. TYSON. Well, first it brings us full circle back to the first question of the chairman, which is in a way when you try to—we are in a situation where we need to use revenues as part of deficit reduction to first of all get a credible amount of deficit reduction, it really requires some revenues, and secondly, we want to do this in a balanced way, but then once we get to that—and then we also have incidentally the goal of trying to restore some of the progressivity into the tax system which really was reduced during the 1980s, but once one begins down that path, of course, problems like this, or issues like this do develop, and they need to be looked at.

Now, it is my understanding that Treasury has, indeed, incorporated these kinds of potential shifts into their revenue estimates of the tax proposals they are making, but I do believe that you should talk to Secretary Bentsen about this and I do believe that we will be working with you to try to make sure that ultimately the tax package that is adopted achieves all of our objectives, deficit reduction, balance, progressivity, and incentives for investment.

I would say those are our main objectives, and to do it in a way which is least distortionary as possible. That is our objective.

Mr. MATSUI. Could I just make one further observation?

Chairman ROSTENKOWSKI. It depends on how long.

Mr. MATSUI. It will be very short. One of the real additional problems with this that I might just point out is the fact that it only applies to individual taxpayers who are in higher than 28 percent rate brackets. In other words, if you are in the 15 percent bracket, you don't get capital gains. If we allow this to be enacted, we really are going to be rewarding those that are in the higher income brackets while giving no incentive to those in the lower brackets. I really think this issue has to be revisited somehow by the administration.

Chairman ROSTENKOWSKI. Mr. Kleczka. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman. This morning, Dr. Tyson, I asked Mr. Panetta what his position would be with respect to PBGC, and the solvency of that in the long run. His reply was that he thought that we ought to pay some immediate attention. He would consider adding, in this year's reconciliation budget, some expression about not allowing this to continue and giving to each committee approximately 5 years to have these books balanced. I liked his answer on that.

I also liked his answer with respect to the Government-sponsored enterprises. He didn't want to see any new ones created during this

term unless they are fully capitalized, and that was clearly understood. Now, I don't know what his response was about entitlements. He also went back to saying that we never are going to cure our problems unless we do something about the entitlements.

Do you know whether the administration has any plans to study or to make recommendations or look at the long-range picture of entitlement programs?

Ms. TYSON. I think that the administration will be looking at that primarily through its health care package, that basically our view is that the issue here is to try to deal with the very dramatic increase both in the public and the private sector of health care spending, and if we could get a health care system in this country which got our costs under control, that that would be the most effective thing we could do.

Mr. PICKLE. Well, that would be perhaps a good beginning, but if you limit it just to health, you are giving no consideration then to agriculture, veterans' benefits, housing, education, and all the other entitlements we have. Are you saying that you have no specific recommendation now except to do as much as you can in the health field?

Ms. TYSON. No, I would say that we have already—on this topic I guess I would say what all of us have said to every committee we have gone before we actually have in our spending cut proposals cuts in agricultural entitlements, cuts in educational entitlements, cuts in social security entitlements.

What I am saying is we have some here already. If we need to go further, we need to go further in a dialog with recommendations from the Congress about exactly where they wish to go.

Mr. PICKLE. I don't argue that you do have some in there, but you are really just blowing a kiss at it right now. It is not a real attack on it. I think you are going to have to look at this as a whole. I really think that this committee and some of the appropriate committees may have to officially have a hearing on the subject of entitlements.

I don't know who is going to volunteer first, but I think it has got to be approached. Now, you are asking us to take this package, and that is important. It is a rather courageous proposal you are making down the street. I would think, under normal times, both Democrats and Republicans would say this is a bipartisan approach. We know nobody questions that the only way you are going to get rid of the deficit is to cut spending and raise the revenue, we know that.

Now we are being asked to pass a package and look at the package overall. We are going to vote on this budget, your full budget. We are taking a lot on faith because we haven't been given the little line markers. I am just going to assume you are going to spell this thing out. I wish we could get more information in advance.

I wish there was some way, Dr. Tyson, and this is just an individual wish, that we could take all this money we are going to raise with revenues and cutting spending and earmark it specifically for the deficit. If that could be done, I think the American people would rise up and say we call your name holy, and they would cooperate with you.

We have never done that because you just don't like to earmark funds. We may come to that point some day. In the meantime, we have got to take it on faith that the deficit will be cut, and I hope we can do it. I think it is the best approach. I am saying to you if, at the end of this administration, we haven't cut back on that deficit, your goose is cooked, and so is the Congress.

Chairman ROSTENKOWSKI. Your time has nearly expired, Mr. Pickle.

Mr. RANGEL. Take your time, Jake.

Mr. PICKLE. We are concerned about it, and I just have to press myself. I notice you do not have any capital gains here other than with respect to small business. I am a little bit disturbed and may be asking in writing for your definition what is productivity, and what is investment. I don't really know if, for instance, an investment tax credit would be an investment. Is Head Start an investment in your view?

Ms. TYSON. I think Head Start is absolutely an investment. The studies on Head Start in terms of the return, you save $3 to $4 for every $1 you invest. This is basically—the program has been analyzed in terms of future performance in school, future ability—future capability to achieve skills for the work force. I think this is definitely an investment.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman. Dr. Tyson, let me say as a member of the loyal opposition, I think the President has fielded a very strong team to move this package up here and through here and out of here. His sales people are very well informed, and are difficult to rebut, but I would have to assume that what you are up here saying today is that the reason for the stimulus package is that it is necessary to move simultaneously a track of public investment and private investment that stimulates growth in the economy, provides jobs, and does not exacerbate the deficit.

That is the ultimate goal of this triparte package of deficit reduction, stimulus and investment. Am I correct in that assumption?

Ms. TYSON. Yes.

Mr. GRANDY. Well, obviously you know the Director of the Congressional Budget Office. You are now using his figures or so we are led to believe. He says this in his most recent report which I gather that you have looked at. It is the "Economic and Budget Outlook" for 1994 through 1998.

He says the Congressional Budget Office's review of the evidence suggests that the measured returns from the average public investment in infrastructure and in research and development have been lower than the returns from the average private investment.

There is little evidence on the economic returns from most government investment in human resources, which I assume includes things like Head Start and national service and some of the things that we may quibble whether they are investment or consumption, but I don't mean to do that right now.

Here is my point. One of the first points that was made in this hearing today by the Chairman was in relationship to the investment tax credit and also the small business capital gains tax. It concerned whether or not those have a real stimulus or whether it is a temporary sparkplug to the economy. It is a change in the

code, a temporary change in the code, and it is going to change tax planning in the short run. My concern as a Member who has only been a member of this committee a little over 2 years and has already been a coconspirator in screwing up the code to pay for unemployment or changing various provisions, is that we usually do more harm than good in an attempt to carve out these little temporary tax credits and stimuli. Instead we are confounding the long-term plans of business, even the ones that could use it, and can afford to hire the accountants. My concern is based on what Mr. Santorum said, who used your own numbers to prove that there is only about a one-tenth of 1 percent end change in unemployment between doing nothing, so to speak, and using the President's plan.

I am afraid that the stimulus may back up on us with a temporary set of tax cuts that will change the timing of investment but probably not permanently increase investment. Do you agree with that?

Ms. TYSON. I guess I want to say two things to that. One of the reasons for using this approach is that the evidence, the economic evidence on the use of investment tax credits as opposed, say, to something like a capital gains tax relief approach is that investment tax credits, what we know about them from econometric evidence and past economic history is they do, indeed, give a boost to private investment spending.

You do, indeed, observe private investment spending increasing as a result of this kind of targeted approach, so——

Mr. GRANDY. But excuse me——

Ms. TYSON. Can I just continue because the second point is related to this?

Mr. GRANDY. OK, sure.

Ms. TYSON. The Treasury has tried to handle the problem of the bunching of investment that might occur through this—through essentially a correction in the outyears, so then if a company sort of invested everything in 1994 and then did nothing in 1995 and 1996, in fact they would have to essentially make good on some of the credits they have received, so recognizing that there is, when you use this kind of credit, the possibility of encouraging a firm simply to bunch rather than to actually just increase their investment and then go back to their normal path, we are trying to structure that in such a way that you get the increase in investment and then back to the normal path, so we are cognizant of this problem.

Mr. GRANDY. But if I understand my history of the code, the reason we have always wound up passing an investment tax credit and then repealing it is that it affected the timing. In a sense it also picked winners and losers.

I can recall in 1986 when I was running for Congress in Iowa the investment tax credit was a dirty word because it was basically enfranchising dentists and doctors who lived in Denver and Philadelphia to buy livestock operations which were driving small producers out of the business.

My concern about this is I don't think there is any kind of data that we have that says a 2-year ITC over a certain threshold is really going to make long-term changes. We know it will make

long-term changes in tax planning which will confound a lot of investors. I see my time is almost up, so going back to something Mr. Matsui said. If it is true that we are going to use taxes to pay for some of these tax credits, and if it is also true as he estimated, I believe that the energy taxes raises $71 billion over 5 years, and that will have no real profound effect on the economy, then how can it be that a $30 billion stimulus over the same amount of time will? Any stimulus. That is my concern.

I think we are making Tax Code complications and tax increases to pay for tax breaks that are marginally disseminated throughout the economy.

Can she respond, Mr. Chairman?

Ms. TYSON. On the energy tax——

Chairman ROSTENKOWSKI. One minute, Doctor.

Ms. TYSON. On the energy tax versus the ITC, I think the way you would describe it, the energy tax is a very broad-based tax, it falls across all regions, all industries, all consumers in the economy, it ends up being very small for any one of them. The ITC is very targeted it is very short term. The way we have tried to fashion it, albeit with some difficulty, you can't get these things perfect, is we are able to give a temporary upward hit to investment and then bring these companies back down to what would have been their normal trajectory. I think that is why you sort of see it differently. Could I clear up one confusion?

Chairman ROSTENKOWSKI. Sure, Doctor, go right ahead.

Ms. TYSON. The confusion I want to clear up is between the CBO economic forecast and our economic forecast because something in the last round of questioning suggests that we are not doing much better than doing nothing.

Now, this CBO economic forecast here was made on the assumption that there would be no deficit reduction. They were saying this is what is going to happen to the economy if we basically muddle through as is, ok? Now, think of it, we are going to give this society back a tremendous amount of investment resources, a tremendous amount of investment and prosperity for the future, high real wage growth in the future, yet we do it in such a way during this period of very difficult deficit reduction program, the economy actually does better than what the CBO is saying it was going to do if we do nothing.

Doing nothing is easy relative to what we are asking our society and our economy to do, so I want to point out that this doing better than the CBO is really doing better. It is doing better because we are going to get our longrun prosperity in hand, and that is a big accomplishment.

Chairman ROSTENKOWSKI. Mr. Brewster. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Dr. Tyson, Mr. Rangel is behind me, and he has had a longstanding interest on a similar issue, it is the issue of enterprise zones.

Ms. TYSON. I just want to tell you one thing. We found out a little bit on this estimate of numbers here just before you go on, I want to apologize, one document doesn't give a final number, the Treasury document suggests that we were considering the number 50. I suspect that in the Treasury proposals out there now we are in the order of a range of 50.

Mr. NEAL. OK. I know you mentioned 30 before.

Ms. TYSON. I want you to know to clarify that.

Mr. NEAL. Are they only going to be targeted to large cities or will medium-sized cities be considered for that plan as well?

Ms. TYSON. As I indicated in my comments, the actual criteria of selection is something that I think we would be negotiating with Members of the Congress, with members of the interested agencies, with members of communities.

We really were talking about, given the kinds of tax incentives we wanted to offer and given a rough regional breakdown between urban areas, rural areas and Indian reservations, we costed these things out, but we did not lay down the exact criteria by which a particular area would be adopted as a zone or not.

Mr. NEAL. How quickly would you be prepared to move on those if, in fact, the package is passed?

Ms. TYSON. I think we would be able to move on those relatively quickly because I think the idea is to build upon notions that had been discussed in the last Congress on enterprise zones and to work with a starting base based on criteria that came out of the last round of discussions.

Mr. NEAL. The reason I raise that question is the previous administration accepted applications from across the country, and my hometown in Massachusetts was the only community in Massachusetts to submit a proposal, and I would hope that in a sense that would be grandfathered, at least that an opportunity would be there to scrutinize that proposal. I bring that to your attention now so that you can keep that fixed in your memory.

Ms. TYSON. Look for that proposal, we should dig that proposal out.

Mr. NEAL. You will have to deal with some of the parochialism that occurs up here from time to time. Secondly, as you make your projections, one of the things that caused all of us a lot of consternation with the last administration, not that they necessarily are obligated to have a better handling on these issues, but as they made their projections about inflation and interest rates and growth, how could they have been as far off as they were at the time?

I sat next to Michael Boskin one night at a sports gathering, and he was as frustrated as anybody I had ever talked to about the projections that were being made, genuinely frustrated.

Ms. TYSON. Well, of course I wasn't there at the time. I will say something about the past projections. In Alice Rivlin's testimony for her confirmation, she actually put together some numbers comparing administration forecasts, CBO forecasts, and private forecasts. I have to say that all forecasters were off, all three groups of forecasters were off.

The administration forecasters erred much more on the side of optimism, on growth rates, so that when you looked at them, they all tended to be off, they all tended to overestimate what the growth of the economy truly turned out to be, but the administration forecasts consistently overestimated in a larger way than the CBO forecasts or the private forecasters.

On interest rates my recollection is the results were somewhat similar except sometimes the administration forecasts on interest

rates were better than the CBO forecasts on interest rates, so the long and short of that is there is some evidence for the notion that the administration forecast did suffer from a rosy scenario bias, but the other thing to say is that forecasting is a very difficult thing to do, particularly over long periods of time, and particularly in situations such as the one we found ourselves in between 1988 and 1991, 1992 when the economy had gone through a substantial debt run up, a substantial investment in overbuilding of real estate, both commercial and residential, so we had some structural problems in the economy which made the recession, I think, last longer and it has been more difficult to get out of than any forecaster predicted.

Mr. NEAL. OK. As an economist, not just as the chief economic adviser to the President, you could answer in one word if you like, do you think the previous administration was overly concerned with inflation?

Ms. TYSON. With the benefit of hindsight, I think that the past administration did not pay enough attention to the growing signs that the economy was getting weaker than they had anticipated and did not take action fast enough to address that.

Mr. NEAL. Thank you, Doctor. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman. Dr. Tyson, I would like to congratulate and commend you as others have on the fine work you have done so far in trying to fashion a program around a set of very difficult issues. I want to ask you one or two specific questions, though, and my hope is to support the thrust of the program and ultimately to support the program.

On mass transit, with respect to the Btu energy tax, for the gasoline taxes and other motor fuel taxes there are exemptions for State and local governments and nonprofits. Do those exemptions apply to the Btu energy tax?

Ms. TYSON. I am sorry, which exemptions were you talking about?

Mr. JEFFERSON. For local government, generally the excise taxes for Federal motor fuels don't apply to local governments for mass transit. My question is whether they are also exempted because I don't see anything about it under the Btu energy tax or are they expected to pay those?

Ms. TYSON. OK, I think that——

Mr. JEFFERSON. If they are, we need to fix that.

Ms. TYSON. I think the answer is yes and we should talk about that. In the following sense the Btu tax will not show up at the retail level. What the Btu tax will do is raise the price to the user of fuel, so that any user of fuel, State, local government for any kind of transportation system will pay a slightly higher price as a result of the Btu tax.

I don't believe the way we had fashioned it that we had put in any exemption for any particular category.

Mr. JEFFERSON. I should commend that to your further study because that would create a new and special burden for local governments for cities like the one that I represent and others represent here. We really need to be sure we aren't putting a burden on them

that isn't ordinarily expected to be on their back regarding energy usage.

The other is a question about a long-term issue. The greatest rise in taxation for the middle class in the 1980s, a rise of some several hundred percent was on the payroll taxes. My question is has there been any focus on the long-term effects on this regressive tax burden and are there any suggestions that you have for possible methods of relief either in this program or in some future undertakings that you can see the administration having to deal with?

Ms. TYSON. Well, I think what we have tried to do here is again to try to fashion an entire package which will not in any significant way, any noticeable way increase the tax burden on middle class families but will, in fact, concentrate the tax increases on the upper end of the income distribution, so we really chose to go at the issue of increasing the progressivity of the tax system through the income tax proposals we made rather than through working on the payroll tax side.

Mr. JEFFERSON. The trouble with it is that the disability and medicare trust funds are going to put more pressure on payroll taxes, and it is another matter that I commend to some consideration. The last is there are efforts here to create jobs throughout the program, and one involves the capital gains reduction, 5 year holding period, cut the capital gains tax in half.

My question is can you quantify in any way where these jobs might end up? Will there be jobs created in the inner city areas as a consequence of this or do you have some other plan for that?

Ms. TYSON. I think that is meant, the tax proposal for capital gains tax relief is meant to apply to small businesses regardless of location. I would hope that since access to capital is a major issue for the formation of small business enterprises wherever they locate that, it would have benefits throughout the country in the inner city as well as in other parts of the country.

Let me say that I think our package has a number of other items which really are designed to try to address some of the problems of inner city areas besides the enterprise zone initiative I think the Head Start initiative, I think some of the infrastructure initiatives by being located in urban areas will really address some of the problems of the inner city.

I also think the administration will be looking very carefully to make sure that if the package as a whole in creating benefits for the Nation does not create a balanced distribution of those into the inner city, that we would want to work on additional policies to do so.

Mr. JEFFERSON. Thank you.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Welcome, Dr. Tyson. I believe there is much good will in your proposals, but I believe there is not much stomach. Martin Feldstein says if every tax and spending change called for in the plan occurs and the economy returns to full employment in 1997, the Clinton calculations say we will have a budget deficit at 2.7 percent of gross domestic product, and he reminds us we were at 2.9 percent in 1990.

So since everything in your plan has to work to reach that 2.7 percent, I want to look at the savings that are in your plan, and I am going to run them down. You may not have time to respond to them, but I think this is such an important part of the big picture in determining whether or not this is the dramatic package the Nation really needs. I agree with you, and I am serious when I say I believe there is a lot of good will in your work. It is a critical time for the Nation. I just believe that your assumptions leave a lot to be desired, and therefore I don't see that the package is going to create the strength in the economy that this Nation desperately needs.

First of all, you assume that those who experience higher marginal tax rates as a result of your package will not change their behavior. That is, they will not shelter any of their income. Yet according to Feldstein, if they sheltered just 10 percent, if they reduce their taxable income by only 10 percent, all your revenue will vanish. If they shelter only 5 percent, your revenue projections will be halved, which means that that deficit reduction will be far less than your numbers indicate.

That is one assumption that I think appears to be faulty, because I can't imagine that people won't take action to reduce their taxable income.

Second, you assume small business will invest. I have been a strong and consistent advocate over many years on this committee of expensing tax credits for small business. But how can small business invest? It does take capital. You still have to have money to do it, even with a tax credit. Yet, small businesses under your plan will pay higher taxes because most of them pay as individuals, so the rise in individual rates will directly increase the taxes that small businesses pay.

I agree with you that small business is the only job driver in our economy at this time. So if small business cannot use your investment tax credit, it will make a difference in the results of your package. I would maintain that because you are increasing their taxes through an increase in income taxes, through an increase in Medicare taxes, through an increase in energy taxes, that even the little guys will not have the capital to invest. The big guys, that is, the guys with over $250,000 in income, will have even a higher tax burden.

There are several aspects of your package that reduce investment capital.

So those are two assumptions that I think are very questionable.

A third assumption is equally questionable. You said earlier in your testimony that you didn't know how Europe taxed the energy manufacturers use. I will tell you how Europe taxes that energy. Zero. They do not tax energy used by manufacturers. They do tax gasoline used by consumers. Their consumption taxes are far higher than ours. Not only do they not tax energy used by manufacturers, but they subsidize it.

We are going to significantly increase the taxes on our manufacturers at a time when their competitive margin in the world economy is very, very small, and in some cases practically nonexistent.

You describe it as a slight differential, the differential between your tax on gas and your tax on oil. I don't consider a ratio of 2

to 1 slight. I can tell you many manufacturers in my district can't convert to oil, because there is no natural gas in the rocky hills that I represent. They don't have that choice of going to the lower cost fuel.

There are some manufacturers who without question will experience much higher energy costs under your proposal, and I believe, representing a State that is deeply involved in exports, that will affect their competitiveness, because I know how narrow their margins are.

So I think your assumptions about the impact of the energy tax are faulty. I think your assumptions about the impact of your package on small businesses' ability to grow and invest are faulty.

I think your assumptions about how individuals will respond, and therefore what your revenue estimates will be is low.

And thirdly, I think your assumptions about your ability to enforce your own package are very faulty, because you are setting the example of breaking the very discipline that according to Mr. Panetta is part of your package. It is the same discipline we put in the budget summit agreement. It is the only discipline that ever worked. The discipline is that you pay as you go and you don't declare emergencies.

Last year we paid for unemployment compensation and we paid for the extenders which are in your tax package. Everybody said it was progrowth. Nobody said it slowed the economy.

By setting the example of laying aside the discipline in the only years when it matters, you are proceeding with a tradition of raising taxes the first year, raising spending the first year, and then not maintaining the discipline to cut spending in the out years.

Those things deeply concern me, and I have run out of time. I apologize to you, but I felt it was too important to make my points.

Chairman ROSTENKOWSKI. Mr. Hoagland.

Mr. HOAGLAND. Let me say, Dr. Tyson, I want to commend you for your work. I strongly support your goal of reducing the deficit to 2.7 percent of GDP by 1997. I think that your team has shown a great deal of courage and leadership in putting this whole package together. I tend to support the program.

I would like to see some changes in it, and would like to talk to you about a couple of those, if I might, understanding that these are intended to improve it and to help our ultimate goal of deficit reduction.

I am just back from a townhall meeting in Omaha on Sunday, and people back there clearly want us to take advantage of this moment in history and get just as much deficit reduction as we can. And I guess one message I would like to see you take back to your team is that if there are some additional savings that we can recover in the stimulus package—Mr. Cardin asked you a number of requests about the stimulus package—if in fact the figures are too small to really have that much of an effect on a $5 trillion economy plus I think it would be helpful to us if we could cut back on that spending.

In terms of the investment package, I think any of those figures that could be postponed to realize just as much deficit reduction as we can would be very helpful. I think remembering the arguments that we all believe in, and that is the more legitimate deficit reduc-

tion we can show, the better the effects on interest rates and the better the health of the economy is going to be as a result of that.

But I wanted to ask you specifically about the incremental investment tax credit, the temporary one. My Omaha businesses are telling me—these are some large corporations—are telling me they would be happy to take the incentives, but realistically it is not going to affect any decisions they will make. And my thought is that if the price tag is $9 to $12 billion, and it seems to be something in that range, if that doesn't mean that the administration shouldn't bear really a heavy burden of proof to show us a wise expenditure of funds given the amount, if maybe you could present us in time—we are having a weekend of seminars. Maybe your staff could present us with whatever proof or evidence you have that that is really going to stimulate the economy.

I mean, clearly some of that $9 to $12 billion is going to be windfall. My Omaha businesses are telling me they won't make any decisions based on that because they will invest in plant and equipment when economic conditions dictate. So clearly some of that is going to be windfall.

It would be interesting to get your view on what percent is windfall and what percent will stimulate investment, and the amount of investment it will stimulate, so we can see if the expenditure of $9 to $12 billion is going to effect anywhere near enough productivity on the private side to make it worth it.

If we compare it with a capital gains exclusion—I have been a proponent of the capital gains small business directed investments for a long time, but the Treasury figures show that will cost us $460 billion over 5 years. So I think there the figures are manageable, so it is worth experimenting.

You know, we did repeal the investment tax credit in 1986, when Chairman Rostenkowski worked so hard to simplify the code. I know there were reasons for that repeal. I know GAO doesn't seem to speak very favorably of it.

I would just be curious to know how you would justify that program and whether you are convinced and your team is convinced we wouldn't do better just to apply that $9 to $12 billion to the deficit and then realize the long-term benefits of that.

Ms. TYSON. We can easily provide you some numbers. If you use a range of models, macromodels of the U.S. economy and you put in a tax credit of this sort, you do get a substantial boost in investment. But I don't have the numbers with me, but I would be happy to share them with you and anybody else.

We have looked at that, and of the things in the stimulus list of options we considered, it was the one we kept because when you look at the models across the wide range of models that differ in terms of how they model the behavior of responses to the economy, models consistently gave a real hit to investment from this kind of approach. So we were convinced that this as opposed to other approaches would make sense as a temporary effort to move the investment rate up.

On the small business capital gains tax exclusion, the reason that doesn't cost very much in the first 5 years is because basically you get the exemption for holding something more than 5 years. So

the revenue effects of that are after the 5-year period. They are a very small beginning cost to that.

Mr. HOAGLAND. That is certainly a good observation. It is just on this side of the table, $9 to $12 billion is so much money as we try to recover it from existing programs or we try to generate it through revenue increases, and again, if we can apply that straight to the deficit instead, it might end up having the same effects by lowering center rates.

Ms. TYSON. It is interesting to note interest rates have come down during the period of time when there was widespread acceptance among private forecasters that we were going to have the stimulus, that in fact when the stimulus estimate went from approximately $20 billion to approximately $30 billion, the bond market rate kept coming down.

That is because I think what traders were doing was saying, they are going to do something small up front but they have got such a big package of deficit reduction in the future that is credible, that we can relax about those long-term rates.

So I think that it is important to note that the bond market itself, the capital market itself assumes that that stimulus is going to occur, and nonetheless we witness 100 basis point decline in the interest rate. I think that is an accomplishment.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Welcome, Dr. Tyson. You are the only person I have heard that can make economic forecasts sound so exciting. I will be supporting the package, and I am only going to ask of you as to whether or not you can see your way clear to having your office try to give us an estimate as to what is the cost of crime and drug abuse as relates to the social cost of the criminal justice system, lost revenue and lost productivity.

The reason I ask that is that it took a long time to get the last administration to produce some figures, and when they did, the President's economic advisers and OMB and Treasury said that a low conservative estimate was $300 billion a year.

And I would say to each economist after that, if this is how we go into the arena to become more competitive, why is it that this is so ignored? Why are we willing just to accept the fact that we can spend $20 billion to incarcerate people and get absolutely nothing out of it? Why do we accept the fact that babies born addicted to drugs will cost us $5,000 a day, and that it keeps on "keeping on"?

And it just seemed to me that somewhere along the line, if you see this economic hemorrhage, and we are talking about making America productive, that whether you are talking about 10 or whether you are talking about 100 enterprise zones, you are not really addressing the problem. And I have not heard the President address it in the inaugural address, or his address to the Congress.

I would just ask you, when you talk with your fellow economists, do you see the hemorrhage that is costing us as a budget item that we would have to deal with, at least to acknowledge it is there and see that we have to do something about it?

Ms. TYSON. I would say that I think this package does reflect some of those concerns in the sense that we define, and I assume I know we will be criticized, certain kinds of programs as investments for precisely the reasons you are suggesting.

We have in our investment package drug and substance abuse programs, and we have immunization programs, and we have WIC programs, and we have crime prevention programs and parental counseling programs. And those are in there because we believe if you invest in those kinds of activities, that you will actually improve the longrun returns to society.

Mr. RANGEL. Let me applaud you for those efforts.

When people talk about the investment tax credit, you bet your life, you are investing in human life, and therefore it is going to make them more productive. But when you look at where these hemorrhages really are, the question is whether you are willing to target these areas and make an investment in these areas, because it doesn't necessarily follow that these broad national programs would be able to go after those communities, especially those in the inner cities, that have these unique type of problems that would fester unless they are given special attention.

I mean, if you find three out of four kids in the community ended up in jail, the Head Start is a long-range program to prevent it, and God bless those who thought to make certain it is there. But if you are saying we have got a stimulus package, we have got to create some jobs, and they are coming through your community, the question has to be, will communities such as mine, with untrained people that have dropped out of school, that are hopelessly unemployed, and many unemployable, would they really think you are talking about them when you are talking about creating jobs?

The answer has to be no, unless we are prepared to go in there and make them ready and to give them hope and give them an opportunity to participate. We just can't afford to write them off, because we are paying for them every day. And the fact that they are not working doesn't mean that they are not a burden on us economically, besides the social pain.

And I don't see that in our documents. If you could do the study for me to see what it is costing us, I think that more than anything else would dramatize how important it is going to be for us to address that problem.

Ms. TYSON. Let me just say one other thing. I think that many of the programs discussed in the national document could help the communities that you are talking about, and indeed we hope they do.

We also are putting together a task force to look precisely at the problems of inner cities, and the issue of delivery of these programs to those areas. That is, maybe they are the right programs, but maybe we have a problem between the programs and getting them to the people in those communities who could most benefit from them.

So part of it is going to be to see if we have missed problems. This task force will look to see if we have missed problems, and also to think about ways of linking up the communities with the programs more effectively.

Mr. RANGEL. Who would head up the task force?

Ms. TYSON. I don't think that has been determined yet, but there has been a decision to put such a task force together.

Mr. RANGEL. Can I depend on your office for a study of——

Ms. TYSON. Yes, we can talk about in a little detail exactly what it is——

Mr. RANGEL. I will send something to you with a copy of what has already been done.

Ms. TYSON. With the estimate of the last administration.

Mr. RANGEL. And how they got it, so you won't have to start over.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Dr. Tyson, you are almost through. My question is this. The Btu tax, as you testified, was not implemented simply to put more money in Government's hands, but would also discourage the use of energy, and that much of that cost, increased cost would be passed along to consumers of energy.

Large industries may or may not be able to pass along a portion of their cost to the customers. I listened very carefully to the comments of Mrs. Johnson. Given the vigorous competition, particularly in the international field, many businesses will be disadvantaged.

My point is this. The impact of the Btu tax will be borne by the small business community and the family farmers in this country who are not able to pass along any increased cost to their consumers. They are at the margin already. My question is, how do those people survive?

I think to take advantage of the investment tax credit or other incentives in the package, you have got to have the money to do it, and taxes like the Btu tax will make that impossible.

Ms. TYSON. First let me try again to point out that this tax collects a lot of revenue over a 4-year period. It is very broadly based. It doesn't fall very heavily on any individual agent. We are talking about a 3 to 8 percent increase in the price of various energies. That is one element of the production process.

We have witnessed the 100 basis point reduction in the interest rate, another very important cost of production. This Btu tax by itself at most will raise the overall price level by 0.25 percentage points. But the interest rate effect on industry would be much bigger than that.

So I guess fundamentally, if you look at the Btu tax in isolation, it is not a very big tax. And furthermore if you look at it in terms of the entire package of what else it does for the business sector of this economy, I think on net this is a positive package for American business.

I just want to say something on the European issue. Europe is considering a tax exactly like this, as is Japan. But even if they don't go ahead with them, I have to say that, again, think about why we are introducing this tax. The Europeans have very well-endowed civilian technology programs. They have better trained workers. They have had a lower cost of capital than American companies for a long period of time.

We have a program which is going to give us better trained workers, a better infrastructure for American companies to work with, and more support for their technology, lower interest rate costs, and slightly higher energy costs. The net effect is going to be to improve the competitiveness of American business, not to reduce it.

Mr. CAMP. We are just getting some of the studies back, and I just submit that some say that an average corn farmer in the Midwest would pay at least $600 a year in energy taxes as a result of the Btu tax alone, and that is not an insignificant amount of money.

But I have another area I would like to ask you about. The Chairman also mentioned this. The tax changes that are being proposed will increase the complexity of the tax system and I think make it more unstable and more unpredictable and more difficult for business to plan.

Was there any consideration to the reduction in Government regulation to make it easier for employers to do business in this proposal?

Ms. TYSON. This is a proposal that was directed at the budget and at spending and revenues dealing with the budget. We will be looking on a continuous basis throughout the administration on regulatory burden issues.

The President is going to be making some sort of announcement on the credit issue in the next few days which will deal, I believe, with regulatory burden issues. We are going to be looking at regulatory burden issues in terms of a wider range of issues in the United States: communication policy, telecommunications policy, health policy, environmental policy. So I think that this was not an issue that we directly addressed in the budget package, because it is hard to put a particular number with a particular regulatory change. But this President, as a former Governor of a State, was very concerned about the issue of regulation and its effect on the competitiveness of the State. He is very concerned about that at the national level. So we will be working with all of you on a wide range of regulatory issues.

Mr. CAMP. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Would any Member like to further question Dr. Tyson?

Doctor, let me just say it has been a pleasure having you. This, I think, is your first time testifying before the Committee on Ways and Means.

Ms. TYSON. Indeed.

Chairman ROSTENKOWSKI. I believe you will find that in most instances, we like to cooperate with the administration.

Your view of the world is a lot more optimistic than some of us who have been here for a little while. I think that Rostenkowski, as chairman, is going to swallow very hard, particularly because I see that the Tax Code, which we have tried consistently in this committee to simplify, is going to start getting all mucked up again.

But then again, we have a new leader in the White House. It is a change. I hope that gridlock is gone or it is very sick and will

be gone in a little while, and that we can work out of our economic dilemma and do all the things that you in your very enthusiastic style talk about curing.

So I think that we are going to make some suggestions. I hope they don't fall on deaf ears. I am not talking about revamping the package. I am talking about doing some things that we as legislators recognize can be a problem on the Floor of the House of Representatives, and I am sure the administration will be very receptive to those things.

There is no way in the world we will do anything that is going to destroy the momentum, the feeling among the American people that Congress is going to try to cooperate with this administration.

I think that we have a very, I hope, short experience in getting this done, but it won't be easy, I guarantee you. It won't be easy because, as chairman of this committee for at least the past 12 years, I have never come across a tax that everybody enjoys.

So we will be working with you and with the administration, and I hope that at the end of this journey, that we will come up with a package that we can pass on the Floor of the House of Representatives, and better yet, pass in the Senate.

Thank you very much.

The committee stands adjourned.

Ms. TYSON. Thank you very much.

[Whereupon, at 4:35 p.m., the committee was adjourned.]

[Mr. Brewster submitted the following questions for response by Ms. Tyson:]

CONGRESSMAN BILL K. BREWSTER

QUESTIONS FOR LAURA D'ANDREA TYSON

CHAIR, COUNCIL OF ECONOMIC ADVISORS

COMMITTEE ON WAYS AND MEAN

MARCH 9, 19993

There have been some concerns expressed in this Committee questioning the value of the incremental investment tax credit. I certainly want to encourage business to expand and fuel economic growth. Many small businesses in Oklahoma are planning to take advantage of the tax credit. However, I have also heard from larger operations that the incremental, targeted nature of the ITC will be difficult to administer, difficult to qualify for, and will not stimulate new investment. Further, businesses that have invested large amounts of capital during the last few years will now compete with businesses that did not upgrade equipment until they received a tax subsidy.

1) Did the Administration consider rewarding patient capital by providing capital gains relief? If we combined the expenditures for the targeted ITC and the targeted capital gains exclusion for small, stock company start-ups, could we develop a capital gains reduction that would reward long-term investment without requiring the government to choose winners and losers through the tax code.

2) In addition to the concerns regarding the complexity of the the ITC, some of my constituents have expressed concerns that the ITC encourages purchases of equipment that will not necessarily increase employment, in fact it might encourage investment in automation that might lead to less employment. In developing the ITC, did the Administration consider these factors and how should I respond to my constituents concerns?

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

THE CHAIRMAN

March 25, 1993

Dear Congressman Brewster:

I wanted to respond to your written inquiries about the investment tax credit and capital gains provisions in the President's Budget.

The Council of Economic Advisers believes the investment tax credit is an important part of the short-term stimulus package and the long-term effort to increase the productivity of the U. S. economy.

For businesses with less than $5 million in receipts the Administration proposes a permanent investment tax credit. The investment tax credit rate is 7 percent for investment made between December 3, 1992 and December 31, 1994. Beginning in January 1995 and permanently thereafter, the credit rate would be set at 5 percent. During both periods, shorter-lived equipment will qualify for a reduced rate of credit, similar to the reductions under prior law. The investment tax credit will reduce the cost of investment in all new equipment for these businesses. Approximately 95 percent of all corporations and nearly all unincorporated businesses have receipts under $5 million and thus will be eligible for the permanent investment tax credit.

For larger businesses the Administration proposes a temporary incremental investment tax credit. Rewarding only incremental investment is a new feature of this investment tax credit, although a similar approach has existed for more than a decade in the Research and Experimentation tax credit. The Research and Experimentation credit and the proposed incremental investment tax credit provide incentives for investments that might not otherwise be undertaken and thus induce more investment per dollar of revenue loss. Incremental investment is measured relative to a fixed base. The base is determined by indexing average historic investment for growth in the gross domestic product and applying a percentage--70 percent in 1993 and 80 percent in 1994. All equipment investment in excess of this amount will qualify for a 7 percent tax credit in 1993 and 1994.

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In measuring average historic investment, a firm may either measure investment over the 3-year period 1989 through 1991 or the 5-year period 1987-1991. This flexibility was given precisely to mitigate one of your concerns: the possibility that large investments undertaken in a single past year would create an unreasonably high base against which to judge incremental investments.

The Council of Economic Advisers believes the efficiency gained by targeting the credit to investment that might not otherwise occur is worth the minimal extra effort required to administer the incremental credit. Recall that only the largest 5 percent of corporations in the nation are eligible for this incremental credit. For these taxpayers, the computations needed to claim the credit are relatively straightforward.

Together, the permanent small business investment tax credit and the temporary incremental investment tax credit are estimated by the Council of Economic Advisers to increase employment by more than 160,000 jobs by the end of 1994. In the short-term, jobs are created by both the increased demand to produce new equipment and the increased employment created by the expansion of businesses using the equipment. Your concern that there could be some future job loss from increased automation is well-founded. Increasingly, however, the risk of job losses from foreign competition requires that our domestic employers undertake investment that can enhance productivity. Increased use of capital will allow our relatively higher paid workforce to compete internationally without sacrificing wages.

The Administration proposal also provides a special small business capital gains provision. Under the proposal, capital gains of small businesses held over 5 years will be eligible for a 50 percent exclusion. This provision, as well as the overall deficit reduction provided in the Administration's proposal, is expected to reduce the costs businesses confront when seeking capital for expansion. The Administration believes that more general additional capital gain preferences are not necessary. Under the Administration's proposals, no capital gains will be taxed at a rate higher than 28 percent, and some will be taxed as little as 14 percent. Relative to the higher tax rates on other forms of investment income--the 36 percent tax bracket and the 10 percent surtax on income in excess of $250,000--capital gains income is thus significantly advantaged.

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Please let me know if I can provide further information on any of the Administration's proposals or any particular concerns you may have. I look forward to working with you on these tax proposals this year.

Sincerely yours

Laura D'Andrea Tyson

Laura D'Andrea Tyson

The Honorable Bill K. Brewster
U. S. House of Representatives
Washington, D. C. 20515

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

WEDNESDAY, MARCH 10, 1993

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. This morning the committee continues its series of hearings on the President's economic package and will receive testimony from the Honorable Lloyd Bentsen, Secretary of the Treasury.

Welcome, Mr. Secretary. This is your first appearance before the Ways and Means Committee in your new capacity as Treasury Secretary. We trust that it will be the first of many visits, and we look forward to working with you as we together advance the President's economic program.

I certainly commend the work that has been done so far on the President's legislative package. It is a bold, honest, and credible program. I, Mr. Secretary, will try my best to move it through this committee and through the House Floor, and I know many of us share the hope that it will arrive on the President's desk in good form and on time.

The revenue title of this package has much to commend it. For example, expansion of the earned income tax credit would provide additional needed assistance to many taxpayers. The proposed broad-based energy tax would achieve significant deficit reduction.

In addition, the President's revenue plan would resolve the uncertainty relating to many of the expired tax provisions. Under the revenue proposals, the low-income housing credit, the targeted jobs credit, and the mortgage revenue bond provisions, among others, would be extended permanently.

I must point out, however, my concerns that certain elements of the revenue plan might undermine the principles that guided us in formulating the Tax Reform Act of 1986. I would hope that we can remember some of the hard lessons we learned during tax reform.

One of the most important features of the President's economic package is its effort to reduce the deficit. In fact, the President's plan shares several major themes with the challenge that I proposed in 1990—long-term deficit reduction financed by a mix of spending cuts and revenue increases, including an energy consumption tax. Now there is a new challenge to show the American peo-

ple that the Congress will work steadily to turn the President's program into reality.

Mr. Secretary, this committee is ready to work with you, and I am looking forward to great, profitable sessions for the American people.

I will yield to Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. Secretary and my fellow Texan, it is a pleasure to welcome you before the Ways and Means Committee this morning. You used to be one of my constituents.

While it is your first appearance as Secretary of the Treasury, you are, obviously, no stranger to this room. You probably have a number of fond memories and perhaps some that aren't quite so fond from your experiences here.

We are glad to have you with us today. It is our first chance to talk with you about the President's tax proposals and probably our last chance prior to markup.

I know that the Members on our side of the aisle are going to want to spend our limited time learning more about the specifics of the taxes the President is proposing. While you and your staff have done an awful lot of work helping the President develop his revenue package, I understand that portions of it still are not completed. The summary of the administration's proposals which you provided to Congress is still somewhat short on detail, so we welcome this opportunity for you to enlighten us. We hope that the statutory language will be introduced in bill form just as soon as possible and certainly before we begin markup in this committee. I look forward to hearing your testimony.

Chairman ROSTENKOWSKI. Thank you, Mr. Archer.

Lloyd, on a personal basis, I look forward, as I am sure my staff and my membership look forward, to working with this administration. And, having been with you as a colleague in the Congress, I know that the future is going to be bright for the collegial, real friendship that will exist, and I hope that at the end of our determination that we will have something that the American people will accept.

You may proceed, Mr. Secretary.

STATEMENT OF HON. LLOYD BENTSEN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary BENTSEN. Thank you very much, and, Bill, I appreciate that.

Mr. Chairman, I guess for 22 years I marveled at the power at the other end of Pennsylvania Avenue, and for the last 2 months I have marveled at the power at this end of Pennsylvania Avenue. Many years I have worked with this committee—and the Budget Committee is moving quickly, and I am delighted with that, but I know when it comes to the detail that much of the heavy lifting starts right here. And we have made some very tough choices on the part of the administration, and we are asking you to make some.

I think this is really a turning point in the economic history of our country. We have got a plan that already has resulted in long-term interest rates coming down very substantially. I must tell you

that, in all candor, that we anticipated it, but it has been much more than we had expected, and we are fortunate in that regard.

Of course, I know there are going to be some fluctuations in those interest rates. We can expect that. But there has already been a substantial payoff. We are saving on debt service costs. Americans are saving money on their mortgages. Where they had perhaps a 9 percent mortgage, they are now saving $50, $60, $70, $80 a month as they have refinanced.

We are seeing our businesses able to borrow money, long-term money, at much lower interest rates and being much more competitive with world markets than we have been in the past. Our investment tax credit proposals will help encourage that kind of expansion.

I am also gratified at the strong support we are gaining in the Congress. I applaud the Budget Committee for acting with such dispatch.

And I must tell you that the kind of reception we received from overseas was quite enthusiastic. Eleven days ago in London I met with one of the toughest audiences, the finance members from the six other members of G–7. Those are countries whose financial markets are closely connected to our own, whose purchases are important for our exporters, and working together should help us expand the economy around the world and open up additional markets for us.

The support I saw in London was loud and strong. Where economic growth is concerned, national interests and international imperatives can coincide. Growth is what this American economic plan will help bring about, growth in jobs, growth in investment, and growth in productivity and incomes.

For the United States, a major obstacle to growth has been our budget deficit, and it is the seriousness of President Clinton's deficit reduction package that has triggered much of that support and economic optimism both here and abroad.

I would like to discuss that—the deficit reduction package—with you, first, and then move on to the closely related subjects of our stimulus and investment plans. First, reducing that deficit, something the Chairman spoke to just a moment ago, reduction in U.S. long-term interest rates, economic stability and long-term growth productivity and income growth here at home.

Our trading partners have long urged us to get our own house in order. Anytime we would start telling them what we thought they ought to do, they would say, go take care of your problems at home first. Do something about your deficit, and then come talk to us about our concerns. We have addressed that, and we are responding to that, and they are recognizing that.

That deficit affects every American, every day. It is not just some abstract concept thought about by economists. It means higher interest rate payments on mortgages, on credit cards. It lowers our investment and our standard of living, and it touches every one of us.

The large deficits we face seriously impede investment. When the economy is fully employed, every dollar we borrow as a government to finance consumption is a dollar that is unavailable to the private sector to finance investment. That drain on our savings has caused

our rates of private investment to fall far below those of other major competitors.

And you can see that one in the first chart. As you look at that one and see the investment as compared to France, Germany, Italy, Japan and the United Kingdom, we are below every one of them. The closest one is the United Kingdom that is having its own financial problems at the present time. You are looking at investment on the part of Japan, approximately twice that of ours. That is the sort of thing that we want to turn around in this country if we can.

The willingness of foreign investors to provide funds has compensated for much of the depressed level of savings in this country that reflects, in part, our budget deficit. But this means that we may be drawing on financial resources badly needed elsewhere in the world. It also means that our children are going to have to repay some of the fruits of our investments to lenders in Europe and Japan rather than keeping them here at home.

Large annual deficits also produce a mountain of debt, and the interest on that debt accounts for an ever-increasing portion of the government's budget. These increasing payments squeeze out important government spending, and with this mounting interest burden it is not surprising our spending on public infrastructure is only a third that of Japan's, well below that of other major industrialized countries.

And you can see that problem in the next chart, the ratio of public investment as related to the others. At 1.7 percent, ours is the lowest. The next lowest is that of Canada at 2.9, and Japan is at 6.1. We have to reduce the Federal deficit to lessen the government's drain on national savings, to free up funds for investment, to leave room in the budget for critical domestic programs, to restore our leadership in the world economy, and to make our Nation less dependent on the foreign capital.

President Clinton's deficit reduction plan takes a bold step in bringing that deficit under control. In 1997, when the provisions are fully phased in, this plan will reduce the annual deficit by $140 billion.

Now, I know that we are getting additional steps by Members of the House and the Senate Budget Committees to further cut spending, to increase the deficit reduction plan that that will produce, and we welcome those steps. The President has made some hard choices on spending, and he made sure that the deficit reduction plan is balanced.

In 1997, when the plan is fully operational, half the savings will come from spending cuts and half from revenues. In the years beyond, the proportion of spending cuts remains at least that high. Furthermore, if the Congress adopts the additional spending cuts that have been suggested by Members, I anticipate that that ratio will be higher than the 50 percent that we have been talking about.

This administration's deficit reduction plan differs from previous plans in a number of respects, and that one I can speak of from experience. I know what it is like to receive a proposal from the executive branch, a black box, and then telling us to make the hard choices. That isn't what is done in this instance. You are looking at approximately 150 specific cuts. Furthermore, those savings are

permanent. They are not temporary. This plan is not based on a rosy scenario but rather works off the more conservative economic forecasts of the Congressional Budget Office.

Let me give you just a few details of the plan.

We have taken the first steps to changing our economic course within the Federal Government itself. It is only fair that if we ask America to contribute that we in government make our contributions first. Through 1997, we are going to cut the administrative costs of our departments and agencies by 14 percent, and we are taking our share of those cuts in the Treasury.

Major cuts will be made in domestic non-defense discretionary categories, reducing that spending by $20 billion in 1997. And we will see $37 billion in savings with prudent reductions in defense expenditures. The fair and equitable changes we propose in entitlement programs will save $41 billion a year by 1997.

Now, let me give you a few examples of the entitlement cuts we are talking about.

In the area of farm subsidies, I understand the problems that our farmers put up with to provide us with the best agricultural products in the world—I am still involved in farming in south Texas—but we need to make some changes. There are some people who farm who also earn more than $100,000 a year from activities that have nothing to do with feeding or clothing Americans. That $100,000 is a good income, anyplace in America. We will end agricultural price supports to these individuals. It is only fair that subsidies end for those who do not need them.

Our plan also will make prudent cuts in the medicare provider payments without—and let me repeat that—without reducing the care available to medical beneficiaries. Our plan does not raise premiums and, hopefully, it may reduce out-of-pocket costs for medicare beneficiaries.

The largest and most sensitive of all, of course, is social security. We propose no change in social security benefits or the cost-of-living increases. But for upper-income recipients, the plan increases the percentage of their social security benefits subject to tax from 50 percent to 85 percent. Now, that brings their taxes more in line with the treatment of other pension benefits. Revenues from this proposal go into the medicare trust fund, a trust fund that is expected to be in real trouble by the year 2002 unless we do something to bolster it.

Now, let me turn to the revenue side of the deficit reduction package. Here the President's plan moves to bring about more equity in taxes. Throughout the 1980s, our most wealthy citizens benefited disproportionately in relation to middle-income working families. Now, as this chart shows, the wealthiest one percent over here on the right had an increase in their income of almost 50 percent while their taxes went down approximately 25 percent. The President's plan reverses that pattern.

The revenue changes we propose restore greater progressivity to the individual income tax system. Families with about $180,000 in adjusted gross income will have their rate increased from 31 percent to 36 percent. Furthermore, a 10 percent surtax is levied on those with taxable incomes of $250,000 or more. Those changes will

affect only the wealthiest 1.2 percent of American taxpayers. Those rate changes won't touch middle income families at all.

Higher-income workers will also be required to increase their payments under the medicare tax. The proposal eliminates the current cap of $135,000 on earnings subject to the hospital insurance portion of the payroll tax, and the revenues from that proposal will go to the health medicare trust fund, further extending its period of solvency.

In addition, we are asking corporations to contribute their fair share. Forty years ago, approximately one-quarter of government revenue came from the corporate tax. Now it is just about 9 percent. We propose raising the top rate from 34 percent to 36 percent for corporations with incomes over $10 million. That change will affect approximately 2,700 corporations out of 2.2 million.

Now, in dealing with corporate tax provisions, our plan also recognizes there are some deductions such as business meals, entertainment and club dues that should be reduced or eliminated.

We also make certain that foreign businesses pay the taxes they owe in the United States, and, to do this, the package has a series of international compliance reforms. The principal provision would require multinational enterprises to establish their transfer pricing methodology before they file their tax returns.

Now, to ensure that we get the most revenue possible from existing taxes, the package also includes a series of domestic compliance measures. The tax gap—the difference between what people owe in taxes and what is actually paid—is a persistently large number. Much of that is because of unreported income, often by business. The package has several provisions, one that raises over $2 billion in 1997, to help us get at this problem.

And, finally, the plan also provides a broad-based energy tax. That proposal has three important goals—improving our environment by effectively taxing pollution, reducing dependence on foreign oil, and cutting the deficit.

Now, the President carefully thought about how this energy tax will affect Americans. Our objective was to be as regionally neutral as we could. We chose a Btu tax rather than going after any specific fuel like imported oil or gasoline or coal. We will apply this tax to fossil fuels, coal, oil, and natural gas, and we will work with you for a system to collect it effectively and efficiently. And there we really want your input.

Along with our energy tax, we propose extending the 2.5-cents-per-gallon tax on motor fuel which was set to expire in 1995. That money will go toward replenishing the highway trust fund for investing in our public infrastructure.

In this country, we have relied on cheap energy for years. Even with our energy tax, our rates will be far below the tax rates charged by many of our G–7 partners. For example, even with the new taxes, the price of a gallon of gasoline in the United States will be roughly $1.20. In France and Germany that gallon of gasoline costs nearly $4.

The President has been very concerned about how the energy tax will affect American families. With the Earned Income Tax Credit and with changes to the Food Stamp and the Low Income Home

Energy Assistance Program, families with incomes of $30,000 or less pay no, or virtually no, additional tax under our revenue plan.

In fact, if you look at the next chart, you will see that, on the average, a family with an income of $40,000 a year will pay just $17 a month more in 1997 when it is fully in effect. Let me remind you that the lower interest rates that are coming about will save those people much more than that $17 a month.

While raising taxes is never easy, let me put the magnitude of this tax increase in perspective. I think this is important for us all to understand, and for the American people to understand, about just what the tax load is after we get through with this as compared to other countries around the world.

This chart shows the total tax burden in the United States compared to other industrialized countries. Remember, the figures include all taxes raised by all levels of government. You can see that even once the new taxes are introduced, our total tax burden is lower than that of other industrialized nations.

Let me give you an example of this. Even after taking account of the economic package, Mr. Chairman, you are going to show us at 32.8 percent. And this is as it is now. And if you can see that sliver of red across the top, that is the new tax. After that is all in, here we have France at 46.5, Germany at 43.4, Italy at 42.1, Japan at 34.6, U.K. 40, Canada 41.6. Ours is the lowest by a substantial margin.

I think that long-term deficit reduction is going to have a major impact on the continued health of our country, but we also need to take immediate action to create jobs and to stimulate investment spending. Thus, we are proposing a modest stimulus for the immediate problems facing us, and an investment package to shift America's priorities toward the future.

February's employment results were better, better than expected, and we sure welcome them. But nearly nine million people are still unemployed, and a record number of people have been out of work for extended periods of time. In California, the unemployment rate is 10 percent. Even with the good February numbers, job growth in this recovery is meager compared to the comparable stage in previous recoveries. With a large number of people out of work, and underutilized factories, we are operating well below our capacity. And with that much excess capacity, inflationary pressures are largely absent. Clearly, there is both the need and the opportunity to achieve higher rates of real growth.

Roughly half the money in the stimulus package goes for tax incentives to stimulate private sector investment. Specifically, the plan includes a temporary 7 percent incremental investment tax credit which goes to large business, and a permanent investment tax credit phased down from 7 percent to 5 percent in two years on investments by small businesses. Small businesses are vital to our economy. They are a major source of new jobs.

The other half of the stimulus accelerates spending for programs that serve the twin objectives of enhancing long-term growth and jump starting the economy. For example, it increases spending for highways and mass transit systems, and it invests in disadvantaged youth by creating roughly 700,000 jobs this summer.

On an annualized basis, it will create about half a million jobs. It takes 700,000 young people off the streets. Americans need jobs. They deserve them.

In addition, too often we have seen businesses which create jobs having trouble getting the credit they need to expand. The Treasury Department's Comptroller General, in cooperation with the Federal Reserve and the FDIC, is working to alleviate the credit crunch and free up capital for small and medium-sized businesses. The President will be having something to say this afternoon about our steps to relieve this impediment to our recovery.

The stimulus package and our efforts to alleviate the credit crunch are what must be done to tackle today's challenge. Yet we all know that is only half the battle.

Our investment package is designed to reverse the Nation's stagnating productivity and wage growth. As this chart shows, the growth in output per worker has practically ground to a halt over the last two decades, and real wages have hardly budged at all. As a result, average Americans have seen little increase in their living standards. This means that simply recovering from this recession is not good enough. We not only need to create more jobs, we also need better jobs with higher wages.

There is little doubt that underinvestment in private business capital and public infrastructure and in the skills of the American work force has contributed to slower productivity growth and better wages.

As I said before, America devotes a much smaller part of its gross domestic product to public and private investment than any other developed country. We have also neglected investment in our citizens. For example, our students repeatedly score below their counterparts in other developed countries in math and science tests.

More investment is critical to improving productivity, wages and living standards. The investment package contains two major efforts to improve both public and private investment. The investment package will start shifting the composition of the Federal budget from consumption to investment. It will expand America's capacity to produce and offer better opportunities to workers. It will bear fruit long after the current recovery has been firmly established. The package includes both tax incentives and public investment expenditures.

The tax side of the investment package includes two important provisions for small business since small businesses are a major source of new jobs. First, small business will continue to enjoy the permanent investment tax credit that is introduced in the stimulus package. Second, we propose that investors in small corporations be able to exclude 50 percent of the gain in stocks held more than five years. This exclusion is carefully targeted to small growth companies and to avoid abuse.

As was cited by the Chairman a moment ago, with respect to the tax shelter concern—we are not trying to build up a bunch of tax loopholes or shelters in the process. Both small and large capital-intensive corporations paying the minimum tax will benefit from the simplified and enhanced depreciation provisions included in the stimulus package. This proposal substantially enhances the invest-

ment incentives for these taxpayers by using the shorter regular tax depreciable lives for the minimum tax as well as the regular tax purposes. This proposal builds on important work done in this area by this committee under the leadership of Chairman Rostenkowski.

In addition, the tax side of the package permanently and retroactively reinstates several provisions that expired last June. For example, we make permanent the research and experimentation tax credit to let business better plan future research investments. How many times did business testify before you in Ways and Means, and before us in the Finance Committee, saying "just give us some stability on research, something we can count on?" Here we are talking about making it permanent. To stimulate investment in housing for low-income families, we propose a permanent extension of both the low-income housing credit and the mortgage revenue bond provisions.

Since investment in people is as important as investment in machines, the targeted jobs tax credit is made permanent and expanded to include youth apprenticeship programs.

I can recall in testimony before the Finance Committee having industrialists from Germany and having them tell me one of those things that you think was most important in giving you a competitive edge over your international competitors. I can recall one of them coming on very strongly to talk about the apprenticeship program and what it meant to keep kids from dropping out of high school, some that weren't going to go to college, but could see a meaningful role for them to fill and a way to earn a reasonable standard of living and to get expertise in a job that made that a company more internationally competitive.

In addition, the general exclusion for employer-provided educational assistance is permanently extended.

This part of the program also authorizes the establishment of enterprise zones. We are still refining the details of that one, but the purpose is to provide incentives to hire and train workers and to improve the physical capital of some of our Nation's most distressed urban and rural areas.

These tax incentives in the investment package for the private sector are then reinforced by increased public investment in a wide range of fiscal capital and workers, both of which are critical for productivity and growth. The investments reaffirm the investment themes President Clinton articulated during the campaign.

Mr. Chairman, members of the committee, we have presented detailed, enforceable, credible programs which we think will strengthen our economy and make a significant impact on deficit reduction. It will create jobs, will make and encourage investment in America and in Americans that will produce the economic growth and revitalization we need to strengthen our position of world leadership. It allows us again to be certain we can pass on a better way of life to our children and to our grandchildren.

Throughout my public life I have worked with many of you in this room on the economic concerns of our country, the budget deficit, trade deficits, the growing debt and the other issues we have faced. Today, I think, we stand at a crossroads. Down one path lies an economy with restored vitality, an economy that again is the

strong vibrant force that made us a world leader. Down the other path is a status quo, delay, divisiveness and a price in economic pain that grows tougher the longer we wait to act.

This committee will play a leadership role in determining which course. You can be assured that this administration will work cooperatively with you.

Our approach is not one of confrontation. There is nothing to be gained that way. The job is too important. It took difficult decisions to put this package together. It will take equally difficult ones for you to act. Together we can make a difference about our future.

Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

[The prepared statement and attachments follow:]

Embargoed until delivery
Expected about 10 a.m.
March 10, 1993

Testimony of Treasury Secretary Lloyd Bentsen
Before the House Ways & Means Committee

Chairman Rostenkowski, members of the Committee:

It's a pleasure to join you this morning. For me it's always a special occasion to come before Chairman Rostenkowski, with whom I worked so closely for so many years while in Congress. I look forward to a continued close relationship with all of you.

I have the greatest respect for the work of this committee. It is here that much of the heavy lifting in our government begins. This year will present you with many difficult challenges, but I am confident that you will meet them.

We have reached a turning point in our economic history, and we cannot step back. In the past few weeks the President has detailed a comprehensive plan to restore American economic growth and leadership. It needs your input and we welcome that. I am confident that you will find that time invested in working with this Administration will produce results for all of us and for the nation.

We have a singular opportunity to strengthen our economy, improve our standard of living, and revitalize the American job-producing machine.

On the evening of February 17th, President Clinton presented his vision and plan to you, and to the millions of Americans watching at home. The reception was gratifying, and the momentum has continued to build.

From the moment we began talking about our plan we expected that long-term interest rates would come down. In all candor, the decline has been beyond our expectations. Although there may be some fluctuations, there already has been a pay-off. We're saving on debt service costs. Americans are saving money on their home mortgages and credit cards. Businesses are finding it cheaper to finance new plants and equipment, and our investment tax credit proposals will help encourage that sort of expansion.

I'm also gratified at the strong support we are getting in Congress, and I applaud the Budget Committees for acting with such dispatch on our program. In addition, the response from overseas has been enthusiastic.

Eleven days ago in London I met with one of the toughest audiences: the representatives of the six major industrialized nations which, together with the United States, make up the G-7 group. These are the countries whose financial markets are closely connected to our own, and whose purchases are important for our exporters. Working together should open markets and lead to the type of sustained growth that could increase demand for American goods across the board.

The support I saw in London for this program was clear and strong. Where economic growth is concerned, national interests and international imperatives coincide. And growth is what the Administration's economic plan will bring: growth in jobs, growth in investment, and growth in productivity and incomes.

For the United States, a major obstacle to growth has been our budget deficit. And it is the seriousness of President Clinton's deficit reduction package that has triggered much of the support and economic optimism both here and abroad. I'd like to discuss that with you first and then move on to the closely related subjects of our stimulus and investment plans.

I. Reducing the Deficit

Deficit reduction is the key to a reduction in U.S. long term interest rates, economic stability, and long-term productivity and income growth here at home. Our trading partners have long urged us to reduce our large and growing budget deficits. Now we offer deeds, not just words. And they can count on an investment-led U.S. recovery to offer additional opportunities for their exports.

At home, the deficit affects every American, every day. It is not some abstract concept debated by economists. It means higher interest payments on mortgages and credit cards. It lowers our investment and our standard of living. It touches us all.

The large deficits we face seriously impede investment. When the economy is fully employed, every dollar we borrow as a government to finance consumption is a dollar that is unavailable to the private sector to finance investment. This drain on our saving has caused our rates of private investment to fall far below those of our major trading partners. You can see this in the first chart.

The willingness of foreign investors to provide funds has compensated for much of the depressed level of savings in this country that reflects, in part, our budget deficit. But this means that we may be drawing on financial resources badly needed elsewhere in the world. It also means that our children are going to have to repay some of the fruits of our investment to lenders in Europe and Japan, rather than keeping them at home.

Large annual deficits also produce a mountain of debt, and the interest on that debt accounts for an ever increasing share of the government budget. These increasing interest payments squeeze out important government spending. With this mounting interest burden, it is not surprising that our spending on public infrastructure is only a third that of Japan's and well below that of other major industrialized countries. You can see the problem in the next chart.

We must reduce the federal deficit to lessen the government's drain on national saving, to free up funds for investment, to leave room in the budget for critical domestic programs, to restore our leadership in the world economy, and to make our nation less dependent on foreign capital.

President Clinton's deficit reduction plan takes a bold step in bringing the deficit under control. In 1997, when the provisions are fully phased in, this plan will reduce the annual deficit by $140 billion. We welcome the additional steps to by members of the House and Senate Budget Committees to further cut spending and increase the deficit reduction that the plan will produce.

The president made hard choices on spending, and he made sure that the deficit reduction plan is balanced. In 1997, when the plan is fully operational, half the savings will come from spending cuts and half from revenues. In the years beyond, the proportion of spending cuts remains at least that high. Furthermore, if the Congress adopts the additional spending cuts that have been suggested by members, I anticipate this ratio will be higher than 50 percent in spending cuts.

This administration's deficit reduction plan differs from previous plans in a number of respects -- and here I really can speak from experience. I know what it's like to receive a proposal from the Executive Branch that promises vague cuts and then asks Congress to make all the tough choices.

This package doesn't use the rhetoric of across-the-board cuts, while dodging the reality of who gets hit; it offers 150 specific cuts. Furthermore, the savings in this plan are all permanent, not temporary. Finally, this plan is not based on a "rosy scenario," but rather works off the more conservative economic forecasts of the Congressional Budget Office.

Let me just give you a few of the details on the plan. We have taken the first steps to changing our economic course within the federal government itself. It is only fair that if we ask America to contribute, we make our contribution first. Through 1997, we're cutting the cost of running our departments and agencies by 14 percent. I'm taking my share of these cuts at Treasury.

Major cuts will be made in domestic non-defense discretionary categories, reducing spending by $20 billion in 1997. And, we will see $37 billion savings with prudent reductions in defense expenditures.

The fair and equitable changes we propose in entitlement programs will save $41 billion a year by 1997. Let me give you a few examples of the entitlement cuts we have made.

In the area of farm subsidies, I understand the troubles that our farmers put up with to provide us with the best agricultural products in the world. But we need to make some changes. There are some people who farm, who also earn more than $100,000 a year from activities that have nothing to do with feeding or clothing Americans. That $100,000 is a good income, anywhere in America. We will end agricultural price supports to these individuals. It's only fair that subsidies end for those who do not need them.

Our plan also will make prudent cuts in the Medicare provider payments without, and let me repeat that, without reducing the care available to Medicare beneficiaries. Our plan does not raise premiums. And hopefully, it may reduce out-of-pocket costs for Medicare beneficiaries.

The largest and most sensitive entitlement program of all is, of course, Social Security. We propose no change in Social Security benefits or the cost-of-living increases. But for upper-income recipients, the plan increases the percentage of their Social Security benefits subject to tax, from 50 percent to 85 percent. This brings their tax treatment more in line with the tax treatment of private pensions. Revenues from this proposal go into the Medicare trust fund, a trust fund that is expected to be in trouble in the next decade without this funding.

Now, let me turn to the revenue side of the deficit reduction package. Here, the President's plan moves to restore equity to our tax system. Throughout in the 1980s, our most wealthy citizens benefitted disproportionately in relation to middle income working families. As the chart shows, the wealthiest 1 percent of Americans saw their income go up nearly 50 percent while their effective tax rate fell by nearly 25 percent. The President's plan reverses that pattern.

The revenue changes we propose restore greater progressivity to the individual tax system. Families with about $180,000 in adjusted gross income will have their rate increased from 31 percent to 36 percent. Furthermore a surtax of 10 percent is levied on those with taxable incomes of $250,000 or more. These changes will affect only the wealthiest 1.2 percent of American taxpayers. These rate changes won't touch middle income Americans at all.

Higher-income workers will also be required to increase their payments under the Medicare tax. The proposal eliminates the current cap of $135,000 on earnings subject to the Hospital Insurance portion of the payroll tax. Revenues from this proposal also will go into the Medicare trust fund, further extending its period of solvency.

In addition, we are asking corporations to pay their fair share. Forty years ago, over a quarter of government revenues came from the corporate tax. Now it's just 9 percent. We propose raising the top rate from 34 percent to 36 percent for corporations with incomes over $10 million. This change will affect only 2,700 large corporations out of 2.2 million.

In dealing with corporate tax provisions, our plan also recognizes that there are some deductions, such as business meals, entertainment and club dues, that should be reduced or eliminated.

We also will make certain that foreign businesses pay the taxes they owe in the United States. To do this, the package has a series of international compliance reforms. The principal provision would require multinational enterprises to establish their transfer pricing methodology before they file their tax returns.

To ensure that we get the most revenue possible from our existing taxes, the package also includes a series of domestic compliance measures. The tax gap -- the difference between what people owe in taxes and what is actually paid -- is a persistently large number. Much of this is attributed to unreported income, often by business. The package has several provisions -- ones that raise over $2 billion in 1997 -- to help us get at this problem.

Finally, the plan also includes a broad-based energy tax. This proposal has three important goals: improving our environment by effectively taxing pollution, reducing dependence on foreign oil, and cutting the deficit.

The president carefully considered how the energy tax will affect Americans. Our program is intended to be as regionally neutral as possible. We chose a BTU tax rather than going after any specific fuel, like imported oil, or gasoline, or coal.

We will apply this tax to fossil fuels -- coal, oil and natural gas -- and we will work with you for a system to collect it effectively and efficiently.

Along with our energy tax, we propose extending the 2.5-cents-per-gallon tax on motor fuel, which was set to expire in 1995. This money will go towards replenishing the highway trust fund, for investing in our public infrastructure.

In this country, we have relied on cheap energy for years. Even with our energy tax, our rates will be far below the tax rates charged by many of our G-7 partners. For example even with the new taxes, the price of a gallon of gasoline in the United States will be roughly $1.20. In France and Germany that gallon of gasoline costs nearly $4.

The president has been very concerned about how the energy tax will affect American families. With the Earned Income Tax Credit, and with changes to the Food Stamp and the Low Income Home Energy Assistance Program, families with incomes of $30,000 or less pay no, or virtually no additional tax under our revenue plans.

In fact, if you look at the next chart, you will see that on average, a family with an income of $40,000 will pay just $17 a month more in 1997 when all of our changes are in place. Let me remind you, lower interest rates are already saving Americans $60, $80, $100 a month or more on new and refinanced mortgages, so these tax changes are, for many people, already more than paid for.

While raising taxes is never easy, let me put the magnitude of this tax increase in perspective. The next chart shows the total tax burden in the United States compared to that in other industrialized countries. The figures include all taxes raised by all levels of government. You can see that even once the new taxes are introduced, the United States' tax revenues as a percent of GDP are the lowest among the G-7 partners. For us the figure will be about 33 percent. For the Germans, it's more than 43 percent. Even for the Japanese, it is nearly 35 percent.

II. Speeding Recovery From the Recession and Increasing Investment

Deficit reduction will make an important contribution to our long-term economic health. But we also need to take immediate action to create jobs and to stimulate investment spending. Thus, we are proposing a modest stimulus for the immediate problems facing us, and an investment package to shift America's priorities towards the future.

February's employment results were better than expected, and we welcome them. But nearly 9 million people are still unemployed, and a record number of people have been out of work for extended periods of time. In California the unemployment rate is pushing 10 percent. Even with the good February numbers, job growth in this recovery is meager compared to the comparable stage in previous recoveries. With a large number of people out of work, and underutilized factories, we are operating well below our capacity. With so much excess capacity, inflationary pressures are largely absent. Clearly there is both the need and the opportunity to achieve high rates of real growth.

Roughly half the money in the stimulus goes for tax incentives to stimulate private sector investment. Specifically, the plan includes a temporary 7 percent incremental investment tax credit for large businesses, and a permanent investment tax credit -- phasing down from 7 percent to 5 percent in two years -- on investments by small businesses. Small businesses are vital to our economy, since they are the major source of new jobs.

The other half of the stimulus accelerates spending for programs that serve the twin objectives of enhancing long-term growth and jump-starting the economy. For example, it increases spending for highways and mass transit systems, and it invests in disadvantaged youth by creating roughly 700,000 jobs this summer.

On a full-year equivalent basis, the stimulus plan will create 500,000 new jobs overall. Americans need jobs now and they deserve them.

In addition, too often we have seen businesses which create jobs having trouble getting the credit they need to expand. The Treasury Department Comptroller General -- in cooperation with the Federal Reserve and the FDIC -- is working to alleviate the "credit crunch," and free up capital for small and medium-sized businesses.

The president will be having something to say this afternoon about our steps to relieve this impediment to our recovery.

The stimulus package, and our efforts to alleviate the credit crunch are what must be done to tackle today's challenge. Yet we all know that that's only half the battle.

Our investment package is designed to reverse the nation's stagnating productivity and wage growth. As the chart shows, the growth in output per worker has practically ground to a halt over the last two decades, and real wages have barely budged at all. As a result, average Americans have seen little increase in their living standards. This means that simply recovering from the recession is not good enough. We not only need to create more jobs, we also need better jobs with higher wages.

There is little doubt that under-investment -- in private business capital, in public infrastructure, and in the skills of the American work force -- has contributed to slow productivity growth and stagnant wages.

As I said before, America devotes a much smaller share of its Gross Domestic Product to public and private investment than other developed countries. We have also neglected investment in our citizens. For example, our students repeatedly score below their counterparts in other developed countries on math and science tests.

More investment is critical to improving productivity, wages, and living standards. The investment package contains two major efforts to improve both public and private investment.

The investment package will start shifting the composition of the federal budget from consumption to investment. It will expand America's capacity to produce, and offer better opportunities to workers. It will bear fruit long after the current recovery has been firmly established. The package includes both tax incentives and public investment expenditures.

The tax side of the investment package includes two important provisions for small business, since small companies are the major source of new jobs. First, small business will continue to enjoy the permanent investment tax credit that is introduced in the stimulus package. Second, we propose that investors in small corporations be able to exclude 50 percent of the gain on stock held more than 5 years. This exclusion is carefully targeted to benefit small growth companies and to avoid abuse.

Both small and large capital-intensive corporations paying the minimum tax will benefit from the simplified and enhanced depreciation provisions included in the stimulus package. This proposal substantially enhances the investment incentives for these taxpayers by using the shorter regular tax depreciable lives for minimum tax as well as regular tax purposes. This proposal builds on important work done in this area by this committee under the guidance of Chairman Rostenkowski

In addition, the tax side of the package permanently and retroactively reinstates several provisions that expired last June. For example, we make permanent the research and development tax credit to let business better plan future research investments. To stimulate investment in housing for low-income families, we propose a permanent extension of both the low-income housing credit and the mortgage revenue bond provisions.

Since investment in people is as important as investment in machines, the targeted jobs tax credit is made permanent and expanded to include youth apprenticeship programs. In addition, the general exclusion for employer-provided educational assistance is permanently extended.

This part of the program also authorizes the establishment of enterprise zones. While the details are still being refined, the purpose is to provide incentives to hire and train workers, and to improve the physical capital of some of our nation's most distressed urban and rural areas.

These tax incentives in the investment package for the private sector are then reinforced by increased public investment in a wide range of physical capital and workers, both of which are critical for productivity and growth. The investments reaffirm the investment themes President Clinton articulated during the campaign.

Chairman Rostenkowski, members of the committee: We have presented detailed, enforceable, credible program which will strengthen our economy and make a significant impact on deficit reduction.

It will create jobs. It will make and encourage the investment in America, and in Americans, that will produce the economic growth and revitalization we need to strengthen our position of world leadership. And, it will allow us to again be certain we can pass on a better way of life to our children and grandchildren.

Throughout my public life I've worked with many of you in this room on the economic problems of our country -- budget deficits, trade deficits, a growing debt, and the other issues we have faced.

Today we stand at a crossroads. Down one path lies an economy with restored vitality, an economy that again is the strong and vibrant force that has made us a world leader. Down the other path is delay and divisiveness, and a price in economic pain that grows worse the longer we wait to act.

This committee will play a leadership role in determining which course we chose.

You can be assured that this administration will work cooperatively with you. Our approach is not one of confrontation. There is nothing to be gained that way, and the job is too important. It took difficult decisions to put this package together, and it will require equally courageous decisions by each of you. Together, we have the opportunity to make a difference for our future, and we must seize it.

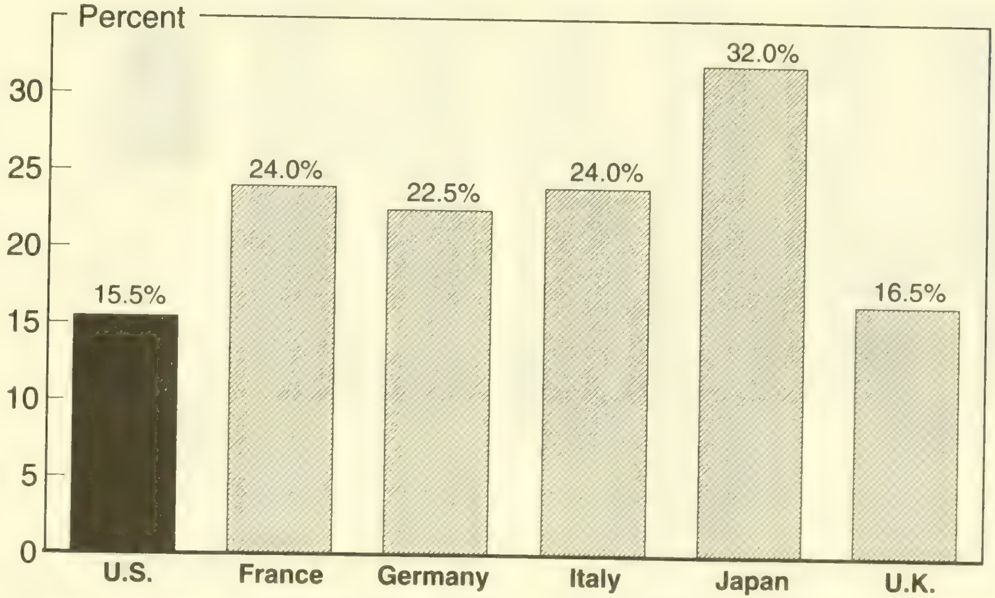
Thank you very much.

* * *

CHARTS TO ACCOMPANY SECRETARY BENTSEN'S TESTIMONY BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

MARCH 10, 1993

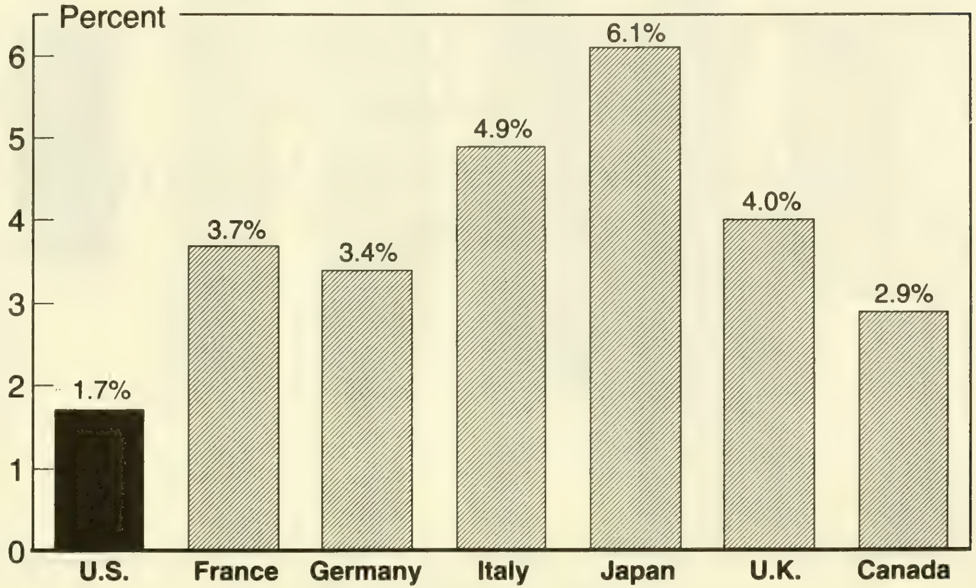
U. S. Invests Less Than Its Competitors



Gross average annual private investment as a percent of GDP, 1980-92

Source: OMB

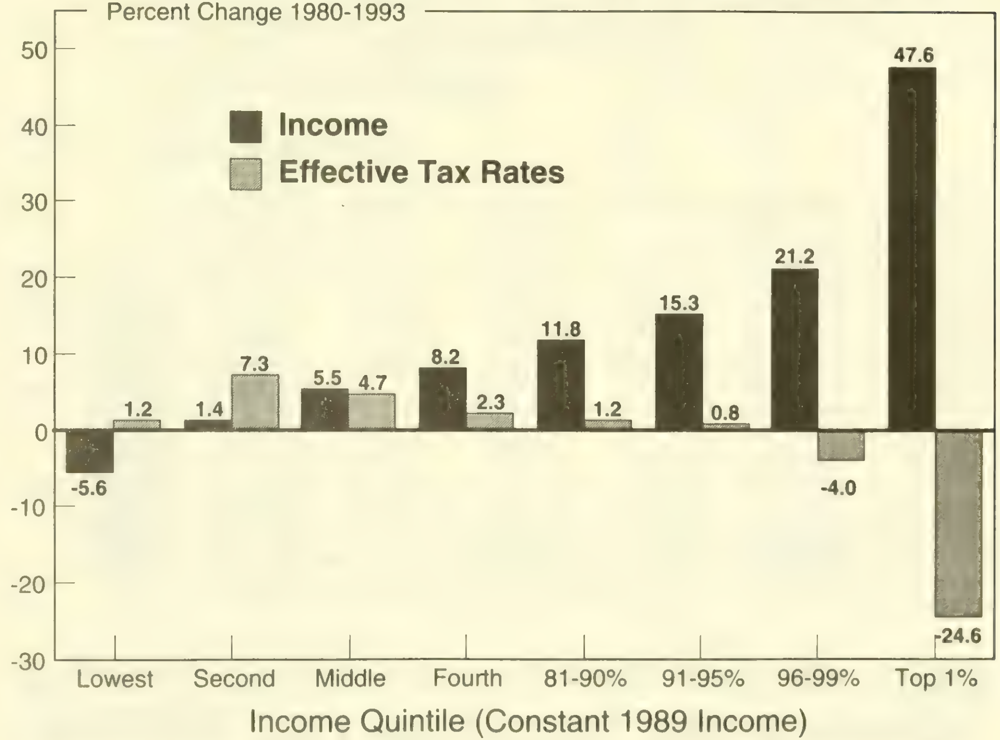
U.S. Public Investment Is the Lowest of the G-7 Countries



Public investment as a percent of GDP, 1990

Source: OECD

Affluent Have Not Been Paying Their Fair Share



Source: 1992 Green Book.

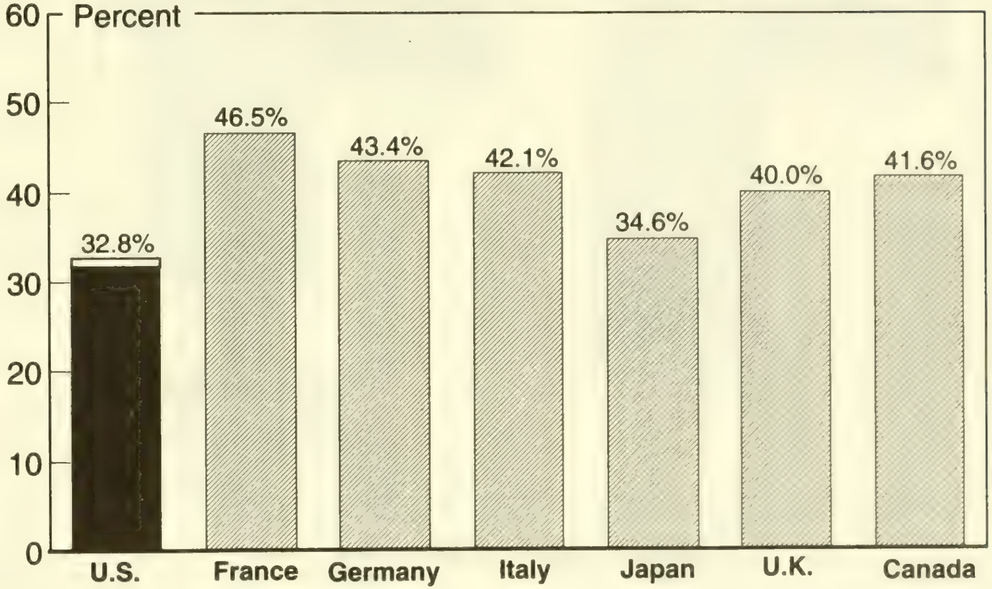
Energy Tax Will Cost the Average Family Only $17 Per Month In 1997

Family Economic Class ($)	Number of Families (Millions)	Average Monthly Energy Tax - 1997
0 - 10,000	14.9	-1
10 - 20,000	18.4	0
20 - 30,000	16.0	2
30 - 50,000	**22.4**	**17**
50 - 75,000	17.9	36
75 - 100,000	9.9	49
100 - 200,000	8.8	76
200,000 - Over	2.4	1,198

Other Benefits

- Reduces Pollution
- Conserves Finite Resources
- Lessens Dependence on Foreign Sources of Energy

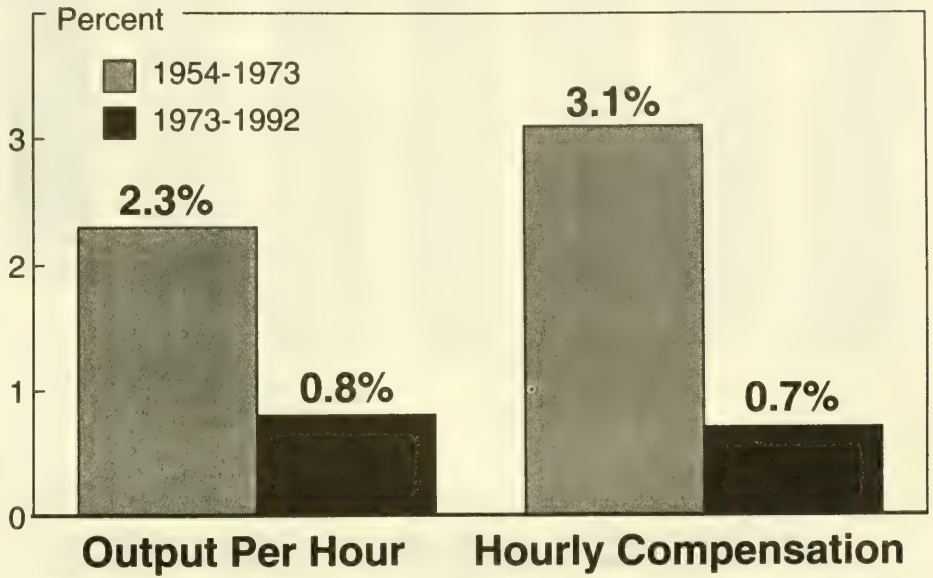
U.S. Taxes Still Lower Than International Competitors



Government receipts as a percent of GDP, 1990

Source: OECD

Output Per Hour and Real Compensation Per Hour Have Grown Slowly



Note: Compensation and output per hour are for the total economy.
Source: Department of Labor

Chairman ROSTENKOWSKI. Mr. Secretary, I want to congratulate you and the administration about this well-rounded and detailed presentation. I don't think in the 29 years that I have served on this committee that I have ever been exposed to as detailed a plan for the country, and I certainly want to commend you. I know that these are hard times, and they will be harder times for those of us in this committee to take the first bite of the apple, but I think that we are going to measure up to the demands of the American people.

Mr. Secretary, one of the investment tax incentives in the President's plan would provide a 2-year temporary incremental investment tax credit. I have heard from several taxpayers that mature industries that have institutionalized long-term investment strategies could not benefit from this rule. Is this a danger with the proposal?

In addition, given our past experience with expiring provisions, do you think there is a likelihood that such a temporary stimulus provision would be the object of intense pressure in the future to extend these provisions?

Secretary BENTSEN. Mr. Chairman, all companies will not benefit equally in this. That is correct. No question about that.

What we were looking for is the most bang for the buck we could get, a leveraged application, a leveraged application with an incremental tax credit. Because we knew there would be variances in the amount of expenditure for equipment amongst companies, one of the things we did was to say that you would get a credit if it was over 70 percent of what you had invested over a set period of time, and then we raised that to 80 percent in the next year.

In addition, we let them choose between a three-year base and a 5-year base to allow them to pick which was the better for them to encourage investment.

As to the next part of your question, anytime you have a temporary tax incentive there is no question but what there are always pressures to extend it. We know that. That is within the judgment of this committee and the administration at that point, but we have no anticipation of such an extension and have no plans for such.

Chairman ROSTENKOWSKI. Well, you know, Mr. Secretary, having sat on this side of the desk, that you never see an incentive in the business community with tax provisions that people don't become attached to and don't start making it part of their way of doing business.

I just remember the 1986 act when we got rid of a lot of these so-called incentives. I am not totally a purist, but I worry about whether or not we are starting on the road of another possibility of us having another run on tax incentives that many of us consider unnecessary loopholes.

Mr. Archer will inquire.

Mr. ARCHER. Thank you, Mr. Chairman.

Lloyd, it is good to have you before the committee. And I wish I could be in total agreement with you on everything, but I don't think you anticipated that.

I do agree with you on the basic effort to get the deficits down. I think that is essential for the future of this country. But, having

said that, of course, we all have different ways that we think are the best way to do it.

I, for one, believe, based on the economic data that I have seen coming in from the outside now and evaluating the President's program, that it will produce an evanescent improvement in the economy and job creation. Obviously, anybody can put a ruler to it and come up with different projections. I am concerned about the major part of the tax increases coming in the early years and the spending reductions occurring in the later years. We have seen that before. That is deja vu of 1990 and other efforts where we back load the spending reductions and put the taxes in up front.

The Budget Committee's analysis shows that in the first year of the President's program there will be a 38-to-1 tax increase to spending reduction, and in the second year it will be 24 to 1. The spending reductions supposedly only kick in in the third, fourth, and fifth year. That all sounds good, but how do you bind a future Congress? I have that general comment. It is not a question.

I would like to devote as much as I can to just two areas of your tax proposal to see if we can get a little bit more detail. Can you tell us on what basis the 85 percent number was picked for the purpose of taxing Social Security beneficiaries? You say that it treats Social Security like other pension plans, and I don't know of another pension plan that is taxed at 85 percent.

Secretary BENTSEN. I said in general it was. As I understand, the way that was worked out was in trying to measure the contributions of people in their Social Security and the payments they made and what that would relate to, and that related to the 15 percent. And then—so the other 85 percent was subjected to the tax.

Mr. ARCHER. Well, I just noticed a recent study on that which shows that people who are retiring now even at the highest participation rate and wage base are not going to get back all of what they paid in. This 85 percent figure is an anachronism, based on the current situation. It may have been true 5 or 10 years ago, but it is not true today.

Secretary BENTSEN. As I looked at those numbers on those projections, they affected individuals in certain categories, and they were prospective over a period of years, so I guess there is some difference, obviously, amongst the so-called experts, the economists in trying to project those.

Mr. ARCHER. Now I would like to talk if I could, briefly, about the energy tax. I think it should be clear to the American people that the taxation of Europeans on gasoline and the price of gasoline is a very, very different thing from the taxation of raw energy. Can you think of another country in the world that taxes its basic raw energy?

Secretary BENTSEN. Well, as I look at the cumulative effect of it with our other taxes, I find that we are still amongst the very lowest of the industrialized countries in the cumulative effect of the taxes they put on energy. And as I look at what it will do for those industries in those other countries I find that the net result to us, even amongst those that use a high percentage of energy, is that we will be quite competitive.

You have to also look at these countries that have a value-added tax and what that adds to it. I was just over in London on the

G–7 meeting, and, as I recall, the value-added tax there was 17.5 percent, so as you look at what it does to their own people, I think that what we are saying with an energy tax for a family making $40,000 a year, the average is $17 a month after it is fully implemented, that we come off quite well.

Mr. ARCHER. Well, you are talking about the impact on the consumer. I am talking about the impact on the companies that have to compete overseas. Is it not true that the value-added tax is waived at the border on all exports?

Secretary BENTSEN. That is correct.

Mr. ARCHER. I am just curious as to how this works because I am told by people in the petrochemical industry that they will be literally put out of business. They will be forced to move their plants overseas. This will be an exportation of jobs and economic activity because this taxes their raw material, their basic energy—which is a product cost—a material product cost.

Secretary BENTSEN. I am told that the energy prices are still much higher in other countries to start with, and we do have a feed stock exemption.

Mr. ARCHER. Oh, I see. You take care of the petrochemical industry by exempting them from this tax? Do you also exempt the aluminum industry?

Secretary BENTSEN. No, we do not. Because there the energy is used in the final product itself. And as we got through studying those numbers—I don't have them here in front of me, but as I recall, it was something on the order in the net increase in their costs of less than 3 percent in that area.

Mr. ARCHER. Well, Lloyd, you are from a business background. For a high volume-low margin product, 3 percent will frequently be the difference between profit and loss. You have spoken of competitiveness of this Nation in the world marketplace over and over again. I don't see how we can remain competitive. I think this is going to export jobs in the steel industry, in the glass industry, in the tire industry, in the aluminum industry, any industry that uses a large amount of basic energy. I don't see how it can help but——

Secretary BENTSEN. Bill, if I believed that, I would fight this. And I don't believe that at all as I have looked at the studies. I think that you get far greater fluctuations in price of materials than when we are talking about a two or a three percent difference. I have been in business where I have seen those kinds of changes, and I have sat on the boards of major corporations in this country before I took this job.

Mr. ARCHER. I know. That is what surprises me about your supporting this provision.

Because we are talking about the basic competitiveness of industries that are essential to this country and driving them offshore. The price of oil in the world marketplace is the same the world over unless I have missed something. I don't understand how we can say we have lower energy prices here than what is in Saudi Arabia or other countries of the world. Clearly, we do not have lower energy prices and I am not concerned about this just provincially for the state of Texas or energy-producing states. There has been a recent study done showing that this tax will cost a million

jobs in the United States of America, and I hate to see us move forward into that sort of a situation.

Thank you very much.

Secretary BENTSEN. Bill, I wouldn't support this if I thought that at all, but I don't believe that. And my numbers show—the study of the economists show that for the aluminum industry that, when the tax is fully phased in, the increased electricity costs are likely to increase the cost of aluminum by approximately 3 percent. You have so many other variables in business that 3 percent is not that major an item.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Secretary, you have convinced me. I am ready to help you get this enacted. And what I really want to know is, what is your time schedule?

Secretary BENTSEN. We are anticipating, with what is happening here, that your budget resolution, hopefully, is going to be out of here before Easter and then you folks in the committees, hopefully, are going to have this thing out by the August recess.

Mr. GIBBONS. Well, is there a part of it you want us to have out before that? Do you want the stimulus package out before——

Secretary BENTSEN. I would like to see them coupled as much as we can.

Mr. GIBBONS. Do you think the stimulus package and the other package ought to be coupled and done by the August recess?

Secretary BENTSEN. I would certainly hope so and anticipate that.

Mr. GIBBONS. Well, that is a pretty good workload for us to have to carry.

Secretary BENTSEN. Let me tell you, Congressman, I found myself on 7-day weeks, 8-day weeks, I guess, and I remember the last couple of weekends ago I left on Friday night to attend the G–7 meeting on Saturday for 7 hours and came back Saturday night—commercial, I might add. I guess I picked up some 9,600 frequent-flier miles for Treasury, but that was about it.

Mr. GIBBONS. I am glad you brought up the G–7 meeting because I am going to throw you an additional burden. I don't believe we can get this Uruguay round completed unless the G–7 gets involved in it and brings it to a conclusion and that the heads of state wind up. But I think it is past the level of negotiation now. It is a political decision that you and the President must make and must wind up. That is no reflection upon Mr. Kantor. It is just that those dogs have been barking at each other's heels so long. I don't see how they can get the Uruguay round wound up without a political decision at the highest level in the world here.

Secretary BENTSEN. Congressman Gibbons, I think that it is in part political. We are looking at some of the political problems of some of these other countries that are making it difficult for them to negotiate, but their leaders are going to have to be a part of this solution.

Mr. GIBBONS. I agree.

Secretary BENTSEN. I think it is important that we get the fast track renewed and that we bring to a conclusion the GATT round. I think that a multilateral agreement is important to the future

trading ability of this country and the world, and we will all benefit by it.

Mr. GIBBONS. The next question is a little different.

Back in 1984 your agency did a great study on the value-added tax. It studied it well and wrote a fine report and then discarded it. I sent you last night on fax—and I am sure you haven't had a chance to read it—my dissertation on that same kind of tax system. I think we are going to have to go to that. I don't expect you to comment on this, but if you get a break and B.A. gives you a little time off, would you read my dissertation, and I would be glad to sit down and talk with you about it.

Secretary BENTSEN. Thank you very much, Congressman.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, it is great to have you here. I think the Congress and this committee look to you more than perhaps anyone in the administration to help us formulate the tax policy and put it in effect because of your experience and your abilities, so we are proud that you are down there.

Secretary BENTSEN. Thank you.

Mr. PICKLE. Let me ask you two or three specific questions, one in the enforcement of transfer pricing, so-called section 482. The administration is recommending, as I understand it, specifically that you are going to encourage companies to "contemporaneously document how they arrive at their transfer prices and explain why they think their prices meet international accepted standards."

Secretary BENTSEN. That is correct.

Mr. PICKLE. I think that is admirable, but that means you are only going after those people under the penalty. You don't really save a whole lot of money by not requiring that people get together and voluntarily agree on how they set standards. I think that is important.

Personally, I don't think that is near enough. I would like to know specifically, if you can tell me, what is the administration's plan so far as personnel is concerned in the enforcement area of section 482?

Secretary BENTSEN. We are planning to beef that one up, to add more personnel to it, to do more audits. I also believe when they contemporaneously do it, do the accreditation that you need, that that gets them thinking about it at that time to justify what they are doing in their transfer pricing and not doing it as an afterthought and then going back and trying to justify it, but, again, we are also adding additional personnel.

Mr. PICKLE. I don't disagree with that. I am just saying, though, that primarily your proposal will affect big companies that are violators. It doesn't touch overall problems with noncompliance.

We have estimated if the U.S. companies pay a certain level of tax doing business in a foreign country; by that same measurement applied to foreign companies here, we think we could be losing as much as $20 billion a year. That is not clearly established, but while you set these arm-length standards, which is desirable, I am glad to hear you are going to beef up enforcement. I have been told that you might be beefing it up as much as 175 people or more. I hope that is true because we have got to concentrate on that. I

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will be interested in knowing what specifically you recommend in that area.

Secretary BENTSEN. I will be happy to do that, Congressman. We have not made a final decision on the numbers.

Mr. PICKLE. Let me ask you, in the area of a bill that this committee has passed twice before—it is what we have called H.R. 22 now, but it was then included in H.R. 11. That is what we call the Good Government Bill.

In that particular bill, Congress has twice passed legislation which contains these provisions: Measures which would stop Federal payment to dead people, curb abusive overtime payments, improve the administration of the medicare program and provide additional taxpayer protection. A couple of those things have been in the President's recommendations.

My question to you is, I would like your staff, Treasury, to work with this Ways and Means staff to see if we could advance that bill, H.R. 22, as a package now because it has already been passed twice. It does everything that you want. And I don't know what your time schedule is, but we would like to advance that—I would personally. Do you have any feeling or are you familiar with that specific proposal?

Secretary BENTSEN. I am familiar with it. You have done some good work there, Congressman. We have staff already reviewing it, but we have not made any decisions as to the specifics. But we are well aware of it and studying it.

Mr. PICKLE. Well, I would like for your staff and my staff to work together to see what we can agree to if we can.

Now, another question I want to ask you is with respect to section 936. I noticed that you are now going to recommend a 35 percent credit with respect to jobs in Puerto Rico. That is, it will be based on credit for wages rather than on just profits that wouldn't be returned to this country. Now, I like that. I hope that you put that into effect immediately or as soon as you can. I think that is a fair way. Now that is your recommendation, and I suppose you support that.

Secretary BENTSEN. We are talking about a 65 percent, not a 35.

Mr. PICKLE. Sixty-five, that is correct.

Secretary BENTSEN. Sixty-five percent credit. It is a phase-in. It has to be because there is an adjustment that takes place in Puerto Rico, and we want to give them time.

Mr. PICKLE. That is right. It is 65. It will be based on wages, and I think that is probably a more appropriate approach on that.

Have you thought about the effect of your proposal on all the money down there that has been built up over the years? Some $12 billion is sitting in the banks, either in the government development bank or in the private banks.

Secretary BENTSEN. We don't see that as a major impact in what they do with that specific money insofar as loans.

Mr. PICKLE. Well, I don't know what the answer is, but there is a lot of money involved there, and I think we have to at some time address it.

Now, one point I want to make to you is with respect to the energy tax. You announced—the administration did—that the collection point for the Btu tax on oil would be at the refinery tailgate.

We are talking about out of the refinery. Now there is considerable debate going on whether it would be out of or as it entered into the refinery. I understand now you—or should I say the White House—may be considering as it enters into the refinery.

Secretary BENTSEN. Congressman, I don't think so. I think it will not be at the input to the refinery. You run into some serious problems on international competition if you try to do that and you put the refineries in this country at risk. I think that would be a serious mistake.

Mr. PICKLE. The refineries in this country just make razor-thin profits now, and if we let that happen, we could drive them all out.

Secretary BENTSEN. You would give international refineries an edge on them.

Mr. PICKLE. Can I ask one final question? You can reply to it later. I notice you have given a one-year delay on taxing home heating oil. That is, it has been proposed. Is that correct?

Secretary BENTSEN. The presentation is a phase-in with a one-year delay. That is correct.

Mr. PICKLE. Well, why a one-year delay on heating oil?

Secretary BENTSEN. To make adjustment. It is a serious problem on heating oil.

Mr. PICKLE. Well, then we want to make some adjustment on diesel, or on some other things. If you give a 1-year delay, we are going to ask for delays or exemptions on other things. Also, remember if you separate the price of diesel and the price of home heating oil, you are going to increase illegal activity and encourage organized crime to concentrate on the home heating oil.

Now, cleanliness is one thing, but if we start making exceptions, Mr. Secretary, we are going to ask for an exception to help our part of the country, too.

Chairman ROSTENKOWSKI. Mr. Houghton, will inquire.

Mr. HOUGHTON. Thank you. I would like to yield to Mr. Thomas.

Mr. THOMAS. Mr. Chairman, I would ask unanimous consent that a statement and questions be placed in the record. I have 27 questions on the Btu tax.

The Secretary knows that I represent a district in California that produces more oil than the entire state of Oklahoma. I have 23 questions about the lobbying expense provision because I am the Ranking Member on the House Administration Committee which deals with all of the election laws. So, rather than try to go through each question, I would like to submit these 23 for the record and ask Treasury to answer them when they can. This will move the hearing along.

Secretary BENTSEN. We will be happy to have them, Congressman Thomas.

[The information follows:]

STATEMENT OF THE HON. BILL THOMAS
Committee Ways and Means
March 10, 1993

It is a pleasure to have Secretary Bentsen before us. His work as Chairman of Senate Finance impressed many of us, particularly those of us concerned about energy. I am looking forward to his discussion of the President's budget proposals today and hope he will be able to fill in some of the enormous gaps in the information available on the budget. Quite a few of us are willing to give the President a chance to sell his program but its hard to accept it when significant parts of it remain obscure. Two examples will illustrate my concern about this program: the Btu tax and the lobbying costs deduction.

As the Secretary knows, one county in my district, California's Kern County, produces more oil than all the states except Alaska, Texas and Louisiana. Most Kern County oil is heavy oil produced through enhanced oil recovery methods such as steam generation, methods which require huge investments in energy as part of the production process. Although producers are shifting to natural gas to control pollution, they have (because they were forced to pay Windfall Profit Tax if they did anything else) burned their own crude oil to make production possible. This is a very sensitive segment of the industry. Heavy crude sells for anywhere from $11.75 to $14 a barrel today, well below the price of West Texas Intermediate crude. For many California producers, those prices are close to, if not at, their break even point. In fact, they cannot easily improve their prices. The U.S. government will not allow them to export significant amounts of heavy oil to other countries and it still forces the bulk of Alaska North Slope production to land and depress prices in California. Under these conditions, you can imagine the sensitivity of producers in my area to the idea of any tax that arbitrarily adds a new cost to their oil. The idea of a $72 billion tax on energy during the next few years is pretty frightening when no one can tell you how it will work.

Because of their concerns, I have already asked the Secretary to answer a list of detailed questions about the Btu tax. The oil and gas industry needs to know about where taxes will be collected and how the taxes will be set, along with other issues set forth in my list. I hope he will submit the answers to the Committee as I know many of my colleagues would also like to know the tax's details.

I would also appreciate having the Secretary's responses to a series of questions I have prepared concerning the lobbying deduction because that proposal too needs a great deal of clarification. The idea is not new as it has frequently been mentioned as a means of financing campaign reform here in the House. As ranking Republican on the House Administration Committee, reform is a subject of considerable interest to me and to others who are concerned about what has happened to Congress. There are a number of ways to treat lobbying costs and some of them create new forms of inequity.

I know there are other areas where the budget proposals are at best unclear to all of us. It is difficult to support something that lacks clarity and, with that it mind, I hope the Secretary will do everything possible to answer questions raised here today as soon as possible.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 11, 1993

The Honorable William M. Thomas
U.S. House of Representatives
Washington, D.C. 20515-0521

Dear Mr. Thomas:

This is in further response to your letter of March 1 enclosing a list of questions concerning the Administration's modified Btu energy tax proposal. You also presented these questions in connection with my testimony before the Ways & Means Committee.

We have been working on this proposal for the last several weeks and have just recently finished the legislative language. Your questions were helpful to us in developing the proposal. I have enclosed our responses to the questions. Please let us know if we can be of further assistance in this matter.

Sincerely,

Lloyd M. Bentsen

Enclosure

Answers to Written Questions Submitted to Secretary Bentsen in Connection with the Secretary's Appearance before the Ways and Means Committee, March 10, 1993

NOTE: Answers to all questions reflect the Administration's proposal as drafted in the legislation introduced to Congress by the Administration on May 3, 1993. As you are aware, discussions are continuing regarding certain aspects of the proposal and are expected to continue during the House Ways and Means Committee markup.

Question 1:

What formula or formulae will be used to set the national Btu rate of fuels? Will it be a weighted average based on fuels used? How often will the Btu rate be revised and by whom?

Answer:

Actual Btu content will be used to determine the tax on coal, and the Secretary of the Treasury (the "Secretary") may require that actual Btu content be used to determine the tax on natural gas. In all other cases, the Btu content used to determine the tax on fuels will be the Btu content specified for that type of fuel based on Energy Information Administration (EIA) data. For this purpose, each of the petroleum products (e.g., motor gasoline, distillate fuel oil) will be treated as a separate type of fuel. The Btu content used to determine the tax on nuclear-generated electricity and hydroelectricity will be the national average of Btus required to produce fossil-fuel-generated electricity. In the case of imported electricity, the national average of Btus required to produce fossil-fuel-generated electricity will apply unless the importer establishes that the electricity was not generated by hydro- or nuclear power and the actual heat rate of the electricity is lower. The Secretary may prescribe regulations to modify the list of taxable petroleum products and to modify the applicable per unit Btu amounts for such products.

Question 2:

Is energy produced from specific sources of energy other than those already specified (geothermal, wind, solar) exempt from the tax? Are nonconventional fuels produced and eligible for the Internal Revenue Code section 29 "nonconventional fuels credit" exempt from the Btu tax?

Answer:

The tax applies only to coal, natural gas, propane, butane, refined petroleum products, nuclear-generated electricity, hydroelectricity, and imported electricity. (A use tax applies to certain uses of crude oil and intermediate refinery products.) The tax does not apply to any energy source that is not derived from fossil fuels, hydropower, or nuclear power. The description of the tax listed solar, wind, and geothermal power as examples of energy sources that are exempt from the tax, but any other energy source that is not derived from fossil fuels, hydropower, or nuclear power will also be exempt.

In general, oil and gas qualifying for the section 29 credit are fossil fuel products and are not exempt from the tax. Gas qualifying for the credit is exempt, however, if it is produced from biomass, or if it is produced from coal seams in certain coal mining operations, but most coal seam or coal bed methane eligible for the section 29 credit is not exempt from the Btu tax. In addition, although synthetic natural gas qualifying for the credit is taxed, the coal used in its production is exempt.

Question 3:

Will the tax imposed on a form of energy be adjusted for regional differences in energy prices or the quality of the energy? If so, how?

Answer:

The tax will not be adjusted directly for regional differences in energy prices or the quality of the energy. However, actual Btu content will be used to determine the tax on coal, and the tax on petroleum products will be based on the Btu content of each class of product. The tax will therefore indirectly take into account regional price and quality differences to the extent these differences are due to differences in the Btu content of coal and classes of petroleum products.

Question 4:

Will energy used by its producer be subject to the tax?

Answer:

The tax will not apply to crude oil or natural gas used, on the premises where it is produced, to produce crude oil or natural gas.

Question 5:

Will energy be taxed if the energy is used to produce other energy (e.g., natural gas used to fire steam generation equipment in secondary or tertiary oil production)? If so, will the taxpayer be given a credit or deduction reflecting taxes paid on feedstocks? Will a tax be assessed if the same fuel burned in production equipment is produced (i.e., oil burned to fire boilers).

Answer:

In general, the energy tax applies to all fuel uses of energy. There are four circumstances, however, in which energy used to produce fossil fuel energy will not be taxed; in addition to the exemption described in the answer to question 4, exemptions are provided for crude oil and petroleum products (other than natural gas) used in a refinery or natural gas used in a natural gas processing or fractionation plant, natural gas and coal used in enhanced oil recovery for heavy oil, and coal and petroleum products used in the production of synthetic natural gas.

Question 6:

Will the Btu tax be deductible from federal income taxes as a business expense?

Answer:

The energy tax will be deductible in computing federal income taxes, generally in the same manner and to the same extent as other federal excise taxes.

Question 7:

Will taxpayers be given credit for taxes paid on energy ultimately used for feedstocks?

Answer:

In appropriate circumstances, tax-free transfers of exempt products (like feedstocks) will be permitted. In all other cases, exemptions will be provided through downstream refunds.

Question 8:

What is the point of taxation for gas and oil? Who collects and pays the tax?

Answer:

The tax on gas will be imposed at the city gate (or equivalent in the case of end users that receive gas directly from the pipeline); the local distribution company (or end user receiving the gas from the pipeline) will be liable for the tax, but the tax will be collected and remitted to the Government by the pipeline. The tax on refined petroleum products (including liquefied petroleum gases) will be imposed at the refinery (or processing or fractionation plant) tailgate; in the case of products removed from a natural gas processing or fractionation plant, the person receiving the product will be liable for the tax, but the tax will be collected and remitted to the Government by the plant operator; in all other cases, the refiner will be liable for the tax and will remit the tax directly to the Government.

Question 9:

Why is the rate on coal substantially lower than that on crude oil?

Answer:

The <u>tax rate per million Btus</u> applied to coal (as well as to natural gas, propane, butane, nuclear-generated electricity, hydroelectricity, and imported electricity) (a rate of $0.257) is lower than the tax rate per million Btus that applies to refined petroleum products other than propane, butane, and residential uses of home heating oil (the basic rate of $0.257 plus a supplemental rate of $0.342, for a total rate of $0.599). Without the higher rate on petroleum products, the energy <u>tax as a percent of price</u> would have been the <u>lowest</u> for petroleum products. The oil supplement rate is designed to decrease imports of oil, thereby increasing our energy security and decreasing our trade deficit. Even with the oil supplement, the tax as a percent of price is not lower for coal than for oil products.

Question 10:

How is product from an on-line natural gas plant taxed?

Answer:

Natural gas will be taxed at the basic rate of $0.257 per million Btus. The tax will be imposed at the city gate (or equivalent in the case of end users that receive gas directly from the pipeline). The local distribution company (or end user receiving gas from the pipeline) will be liable for the tax, but the tax will be collected and remitted to the Government by the pipeline.

Question 11:

Will producers of liquefied natural gas be given a credit for natural gas used in its creation?

Answer:

Although a use tax is generally imposed on fuel uses of natural gas on which the energy tax has not been imposed, the use tax does not apply to natural gas used in a natural gas processing or fractionation plant.

Question 12:

Are exports of fossil fuels exempt or subject to tax rebates? Will the exemption or rebate be applied to raw or to refined products?

Answer:

Exported fuels (coal, natural gas, and refined petroleum products) and electricity will be exempt from tax. The exemption will be through tax-free transfers in appropriate circumstances, and in all other cases through downstream refunds.

Question 13:

Will imported energy be taxed at the same rates applied to domestically-produced energy? How will taxes be assessed on finished goods such as gasoline? Will manufactured goods be taxed based on energy content?

Answer:

Imported taxable products will be taxed at the same rate as equivalent domestic products. The tax on gasoline and other petroleum products (whether domestically-refined or imported) will be specified for each separate type of fuel based on Energy Information Administration (EIA) data. Manufactured goods will not be taxed based on their energy content.

Question 14:

What is the mechanism for exempting or providing rebates for non-fuel use of fossil fuels and fossil fuel exports?

Answer:

Tax-free transfers of exempt products will be permitted in appropriate circumstances. In all other cases, exemptions will be provided through downstream refunds. For instance, fossil fuel exports shipped directly from the producer will be tax-free sales, but other sales will require the shipper to file a refund claim. In addition, refined petroleum products generally used as feedstocks are not listed on the "taxable refined petroleum product" list, and are, therefore, not taxed when sold. Other non-fuel uses will require the taxpayer to file for a refund. Refunds of over $1,000, if for a period of at least one week, will be eligible for an expedited claim procedure under which the Government must pay the claim within 20 days after the date the claim was filed or the claim will be paid with interest. All other refund claims will be paid by the Government without interest.

Question 15:

Why is heavy crude oil which receives approximately $8 in price less than West Texas Intermediate being taxed at the same rate as West Texas Intermediate?

Answer:

The energy tax is not applied to crude petroleum, but rather to refined petroleum products. Therefore, the tax that will be eventually be paid on any barrel of oil depends on the mix of products that is refined from that barrel. To the extent that crude prices reflect differences in refined product mix, the Btu tax will differ across grades of crude. The same Btu tax rates will be specified for each separate type of fuel based on Energy Information Administration (EIA) data, which equalizes the tax on actual output.

[NOTE: No questions numbered 16 or 17 submitted.]

Question 18:

If gas is taxed when it enters the pipeline, how does it become exempt?

Answer:

Natural gas is not taxed when it enters the pipeline; see the answer to question 8 for a description for how natural gas is taxed.

Question 19:

If gas is not exempt, then how will the government refund the tax liability to the taxpayer? Producers believe it cannot simply be refunded against income tax, since taxpayers may be in a loss position.

Answer:

The tax on natural gas is imposed on local distribution companies and end users. Thus, there will be no occasion to refund tax liability to the producer.

Question 20:

What actions will the government take if demand for heavy oil decreases, i.e., since all oil Btus are taxed at the same rate, refiners will want to purchase lighter crudes to increase their margins. What will happen if (when) California heavy crude gets displaced by foreign light crudes?

Answer:

As noted in the answer to question 15, the tax does not apply to crude oil, but rather to refined petroleum products. There should not be the kind of shifting between grades of crude that would occur if the tax were applied directly to the crude, rather than to products.

Question 21:

Who will keep the records required by the tax?

Under the general rule applicable to all taxes, persons liable for the tax, or for the collection of the tax, are required to keep such records as the Secretary may prescribe. In addition, the Secretary may require other persons to keep records sufficient to show whether or not they are liable for the tax.

Question 22:

What procedures will be employed to ensure that products sold for "non-fuel" uses are actually used for those purposes?

Answer:

Generally, most non-fuel uses will require that the tax be paid and a refund claim filed with the Government. Reducing the number of tax-free sales will reduce the frequency of fraud.

Question 23:

Is petroleum coke sold as a fuel taxed at coal rates?

Answer:

Petroleum coke sold as a fuel is taxed at the rate of other refined petroleum products ($0.599 per million Btus).

Question 24:

Are energy imports from Canada or Mexico to receive different treatment from imports sourced elsewhere?

Answer:

Imports of taxable energy products and electricity, regardless of source, will be taxed at the same rate as equivalent domestic products.

Question 25:

How will crude oil or other forms of energy be treated if imported into a Foreign Trade Zone?

Answer:

The tax is imposed on refined petroleum products rather than crude oil. In addition, coal and natural gas are taxed downstream from the point of importation. Thus, crude oil, coal, and natural gas will not be taxed when they are imported into a foreign trade zone. Refined petroleum products will be taxed when entered into a foreign trade zone for consumption, use, or warehousing.

Question 26:

How are MTBE and methanol treated under the tax?

Answer:

Methanol and its ether derivatives, including MTBE, as well as ethanol and its ether derivatives, are exempt from the tax. Feedstocks used in production of these products are also exempt.

Question 27:

Will retailers be allowed to identify the amount of tax borne by a product?

Answer:

We do not have a rule that will prevent retailers from identifying the amount of tax borne by a product.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 11, 1993

The Honorable William M. Thomas
U.S. House of Representatives
Washington, D.C. 20515-0521

Dear Mr. Thomas:

This is in response to your letter of March 8 enclosing a list of questions concerning the Administration's proposal to deny deductions for lobbying expenses. You also presented these questions in connection with my testimony before the Ways & Means Committee.

We have been working on this proposal for the last several weeks and have just recently finished the legislative language. Your questions were helpful to us in developing the proposal. I have enclosed our responses to the questions. Please let us know if we can be of further assistance in this matter.

Sincerely,

Lloyd Bentsen

Lloyd M. Bentsen

Enclosure

Lobbying Expense Deductibility

Q-1: Will deductions be denied for the costs of lobbying government agencies with regard to regulations or other executive actions? If so, under what circumstances?

A-1: Under the proposal, the cost of lobbying government agencies with regard to regulations or other executive branch actions will remain deductible. In designing the proposal we were ever mindful of the fact that the proposal must be administrable as a rule of tax law by thousands of taxpayers. This consideration dictated rejecting some possibilities, such as restrictions on lobbying the executive branch regarding regulations, and recommending that policies regarding these issues be pursued through other means, such as the lobbying and campaign financing reform initiatives.

Q-2: Are deductions to be denied under your proposal for costs of lobbying state or local legislative bodies? Will deductibility be determined on the basis of the state or local government's organization?

A-2: Under the proposal, the cost of attempting to influence legislation by a state or local government will not be deductible. "Legislation" for both Federal, and State and local governments will be defined as under section 4911(e)(2) of the Internal Revenue Code.

These rules generally look to the structure of the government, but they provide some blanket exceptions to promote fairness and uniformity. For example, under the regulations for section 4911(e)(2), changes in local land use rules are generally not legislative, nor are actions by a school board or nay other specialized governmental board or agency.

Q-3: Are the same exceptions in section 4911(d) to be applied to businesses? If you plan to make modifications, what will they be?

A-3: Under the proposal, the only exception in section 4911(d) that will apply is the exception for technical advice.

Q-4: What would constitute a "written request" for information by a legislative body? Would a blanket press release inviting comments on a matter permit respondents to deduct the costs of their replies? Would respondents also be able to deduct the cost of "follow up" information such as that provided in response to a committee member or as a means of providing new or additional information on the subject?

A-4: Under the proposal, the request must be written, requested by a governmental entity, and specify the nature of the advice or assistance. A blanket press release requesting comments would not suffice. Follow-up costs are deductible only if they can legitimately be considered part of the written request.

Q-5: If an exception for "nonpartisan" analyses, research and study is included in your proposal, how will it be applied to businesses?

A-5: The proposal does not provide an exception for nonpartisan analysis, research or study.

Q-6: Are you going to modify the current section 162(e)(2) prohibition so that businesses can deduct the costs of nonpartisan research, study and communication?

A-6: The proposal will not modify the current section 162(e)(2) prohibition to allow businesses to deduct the cost of nonpartisan research, study and communications.

Q-7: Are deductions to be denied for expenses "directly connected" with lobbying or for expenses merely "in connection with" lobbying?

A-7: Under the proposal, all costs paid or incurred in connection with attempting to influence legislation will be considered lobbying.

Q-8: One of the exceptions to the section 4911 lobbying tax allows charities to avoid tax on expenditures in "self defense" when they contact legislatures on matters affecting the organization or its powers or duties. Are you planning to limit the scope of this exception with regard to business, and, if so, how?

A-8: The proposal does not provide a self defense exception for businesses.

Q-9: How successful has the IRS been in enforcing the existing rules regarding lobbying by charities and foundations? How many organizations have been forced to pay tax under the 501(h) elections since it was developed? How many foundations or charities have lost their exempt status because of lobbying during the period lobbying restrictions have been applied to charities?

A-9: The final regulations under section 501(h) were adopted only in December of 1990, preceded by a period of substantial controversy about the proposed regulations. There has therefore been little experience enforcing the final regulations. During this time, little or no tax was paid under section 501(h) and 4911. We believe that, if anything, this indicates that the bright line rules of these sections have successfully performed their intended functions. Few if any charities or private foundations have lost their exception because of lobbying.

Q-10: Does Treasury's estimated revenue gain from denying the deduction assume any "slippage" from organizations converting or creating charities that can, under 501(h) or 501(c) rules, engage in some lobbying? If so, how much of this activity do you expect?

A-10: The incentive to convert or create a charity to engage in lobbying is already present under existing law with respect to grass roots lobbying and nonpartisan analysis. We have experienced little abuse under current and expect little further abuse under our proposal. The reason for this is that current law restrictions on charities make conversion into a charity for the sole purpose of avoiding the lobbying restrictions relatively unattractive. In particular, any charity would have to serve a public purpose rather than a private purpose, so the ability to create these tax-exempt charities will be limited. In addition, charities will be limited in their lobbying, as under current rules. Therefore, businesses will not generally be able to circumvent the nondeductibility of their lobbying expenses.

Q-11: Does your proposal assume that additional resources will be required to conduct audits of organizations that lobby? To what extent might new resources be required to enforce the prohibition?

A-11: The proposal assumes that the IRS will enforce these rules using existing resources.

Q-12: How will the new rule be structured: will all communications be presumed to be lobbying unless otherwise shown, or will the IRS carry the burden of proving that communications are lobbying?

A-12: As under general rules of tax administration, the taxpayer has the burden of proof.

Q-13: The legislative history of the Revenue Act of 1962, from which section 162(e) is derived, shows Congress, Treasury and the public felt that a clear statement on deductibility was needed to prevent endless squabbling about the characterization of lobbying costs. What has changed since 1962 that would make administration of the President's proposal easier?

A-13: The IRS has had to develop extensive regulations defining lobbying by charities under section 4911. The IRS will be able to use this experience to adequately define lobbying by businesses.

Q-14: Will the fact of registration as a lobbying (e.g., with the Clerk of the House) lead to presumption that an individual is engaged in lobbying when communicating with a legislative body?

A-14: Under the proposal, registration will be considered evidence that an individual is lobbying. Because registration rules and the tax deductibility rules may vary, no presumption will required by the law.

Q-15: Will deduction of the costs of a de minimis amount of lobbying be permitted? If so, at what level?

A-15: The proposal includes no de minimis exception.

Q-16: Will taxpayers be able to circumvent nondeductibility under section 162 by making contributions to charities eligible to receive deductible contributions under section 170?

A-16: Charities will be limited in their lobbying, as under current rules. Therefore, businesses will not be able to circumvent the nondeductibility of their lobbying expenses.

Q-17: What costs are to be treated as lobbying: the actual expense associated with a contact (e.g., the lobbyist's salary), the costs of preparation (including such costs as research), ministerial acts (such as the cost of scheduling appointments)? Will organizations be required to allocate a portion of costs otherwise expected of a business (for example, overhead incurred in operating an office used to gather information about legislative matters) to their calculation of lobbying costs?

A-17: Under the proposal, all costs paid or incurred in connection with attempting to influence legislation will be considered lobbying. We hope to work with Congress to address this issue in greater detail, balancing the need for simplicity with that of avoiding abuse of the proposal.

Q-18: How will organizations be required to treat their contributors? Will a new form of reporting be required so that trade associations are required to tell members what portion of contributions are nondeductible?

A-18: Under the proposal, organizations will be required to report to their members the portion of dues attributable to lobbying expenses.

Q-19: If businesses can deduct contributions for nonlobbying trade association work, will the associations be able to lobby using tax-exempt income generated with such contributions without reducing contributions' deductibility or incurring taxes or penalties at a later date?

A-19: Lobbying expenses will be allocable only to dues and lobbying expenses in excess of dues will be carried forward. Therefore, associations will not be able to lobby with tax-exempt income.

Q-20: How will lobbying activity be identified under your proposal? Will the intent of the person making the contact be dispositive or will the determination be based on a retrospective analysis of the facts and circumstances surrounding a contact?

A-20: Under the proposal, lobbying activity will be defined as attempts to influence legislation. The proposal does not include a special intent requirement.

Q-21: Are you planning to allow businesses to deduct the costs of voter education and registration programs along lines under which charities can currently conduct those activities without losing their eligibility to receive deductible contributions?

A-21: The current rules for voter education and registration will continue to apply under the proposal.

Q-22: Do you contemplate any change in the treatment of charities or will their donors still be permitted to deduct their entire contribution so long as no portion of the contribution is earmarked for lobbying?

A-22: Under the proposal, the current rules governing lobbying by charities will apply.

Q-23: During the past few years, a number of House members have urged that the deduction for lobbying costs be repealed as a means of operating taxpayer-financed campaign reform initiatives. Does the President's budget similarly "earmark" revenues from the deductions repeal for campaign financing? If not, are any other tax provisions in his budget intended to provide funds for campaign finance initiatives?

A-23: Some portion of the money raised by the denial of deductions for lobbying deductions will be used to pay for campaign finance reform. We intend to create a trust fund to hold the funds for campaign finance reform. We have not included trust fund language in the proposal because we have not yet received costs estimates for campaign finance reform.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. Secretary, good to see you. I appreciate what you are doing. I appreciate the thrust and the confidence with which you are going about your job. There are certain disagreements I have, but you would obviously expect that.

There are two subjects I am really worried about in terms of the commitment which you have to your plan. You talk about more jobs and better jobs, and yet I see a real issue looming on the horizon because you are taxing business and, therefore, you are withdrawing money that could be invested. That will hurt the poor employment situation. In addition to that, there will be further cuts—and this will probably be announced on Friday—on military base closings.

So there is a drag, then, on the employment situation in this country. Therefore, you would have to look for an increase in the economy to boost the overall volume requirements of business. But the blue chip economists, because of the Clinton program—feel that the economic growth figures are down perceptibly from what they were because of this drag on the economy.

One of the things which has spurred small and medium-sized businesses has been foreign sales. Yet to look to foreign business is, to me, something very shaky because the economies of Japan, Germany, and some of the other countries that really are the motors of the economic world are not that strong. So I see the U.S. employment situation getting very bad because of these programs, necessary as they might be, and yet we can't look to the rest of the world to help our employment levels.

Secretary BENTSEN. Well, I know your distinguished career in business and your understanding of business. What we are talking about here is an increase in the corporate tax from 34 to 36 percent. That is relatively modest. If you look at what the corporate rate is in Japan, it is 40 percent. If you look at what it is in Germany, it is 50 percent. If you look at the percentage of revenue that we used to get back in, say, 1955 from the corporate tax, it was about 25 percent. Today it is about 9 percent, a very material reduction in that.

Then, when you speak of small business, we have particularly addressed small business with a permanent investment tax credit of 7 percent for 2 years, then a flat percent to try to encourage that. Then when we look at what has resulted in the reaction to the deficit reduction that we have proposed with this dramatic reduction in interest rates, what that does in the borrowing of money for small business in particular and what we are talking about in trying to help on the credit crunch which the President will address this afternoon, I think it helps encourage the expansion particularly of small business and the creation of jobs.

Mr. HOUGHTON. Well, I hope that is right, Mr. Secretary. There was a budget reform act of 1990, and that was supposed to reduce the budget deficit $80 billion by 1993, and it is higher today than it ever was. We are now backing away from the things which we believed in, and I hope you don't do that if the employment situation doesn't come along as you expect.

Secretary BENTSEN. Thank you.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Mr. Secretary, welcome. It is really refreshing to see that some of the things we have had to fight for over the years, that you and the administration have incorporated that in your proposal to the Congress, that you can see and feel comfortable in talking about investments in people as well as investments in plant and equipment.

The previous administration, in determining and giving a guesstimate as to the cost of not doing these things as relates to crime and poverty and unemployment and drug abuse and alcohol abuse, claim that it costs us, when you include lost revenues and lost productivity, $300 billion a year. It is almost impossible to get an economist to come up to bat and even discuss that. They say, oh, yes, it is important. Oh, yes, in the long run.

And I think that the Clinton administration is attempting to deal with this in Head Start and WIC and other things. But it would be helpful if your office would prepare some type of analysis as a road map as to where we have to go if, indeed, when people talk about America moving forward, that all of our youngsters, no matter what communities they come out of, believe that you mean them, too. Because so many of our young people-illiterate, unemployable and addicted; really will end up in jail before they will be eligible for any meaningful employment.

So if we know how bad it is, then we as a Nation can attempt to try to overcome it. I look forward to getting that type of information from your office.

Mr. Pickle shares my concern about 936. This has been called one of the most expensive job creation programs in the history of the United States, the widest loophole that American business has ever had.

Last night, some television people said we were exporting jobs to foreign countries, talking about Puerto Rico as a foreign country. But, notwithstanding that, the governor of Puerto Rico indicated that they are not locked into 936, and I certainly am not locked into 936.

I would welcome any alternative that is less expensive and just as effective for these American citizens in Puerto Rico. The problem I have is that no one seems to know how we found out that this wage credit is going to work. The governor says it will have a rapid economic deterioration on the economy of Puerto Rico. And I just hope that you can refer me, Mr. Secretary, to any studies, any hearings.

Because what happens, as a practical matter, is that when Puerto Rico has a cold we in the City of New York have tuberculosis in terms of the number of citizens that come to New York City looking for jobs and looking for a better way of life. And the truth is, that while I don't have a political problem with that, the impact that it has on our schools, our health system, our social service system is just not fair to come up with some formula to make sense without giving the Congress an opportunity to have hearings and to determine how it would impact on the poorest of U.S. citizens.

If they were a state tomorrow—and a lot of this is driven by whether they are going to become a state or whether they remain a commonwealth—they would be poorer than the poorest state we have by 50 percent. And so count me in if you are talking about

decreasing the deficit, getting more taxes from the corporation, lessening the costs per job, but count me out if you can't tell me what impact this is going to have on the people of Puerto Rico.

Secretary BENTSEN. Congressman, I know of your concern for Puerto Rico. I also know of your concern for enterprise zones and the leadership that you have exercised in that area. When we look at some of our areas in the United States, when we look at areas in New York City, Los Angeles, some areas that have higher rates of unemployment, even more serious economic problems than Puerto Rico, and we are talking about incentives to be put in there to help. Then we have to reassess what we are doing in Puerto Rico and trying to help those companies down there.

And as we look at some of the incentives for some of those companies where they were receiving something similar to having an average subsidy in those particular companies of $70,000 per employee, it is time to reassess that.

Mr. RANGEL. It makes sense to me. Count on my support in the reassessment. But, as Mr. Pickle says, let's do it immediately. You are saying we are moving fast on it. I am saying we haven't even had any hearings on it. We don't know what impact this is going to have by doing it right now.

Secretary BENTSEN. Well, that is why I responded to Congressman Pickle by saying we have to phase it in to give them an ability to adjust to it and to see how it is working, to minimize any disruption of employment in Puerto Rico.

Mr. PICKLE. Mr. Chairman, may I comment since he mentioned my name? The administration is just recommending changing the policy on 936 to wage credits rather than on money that kept over there. That is a good, sound approach. There would be a phase-in on it.

We have tried to advance that approach before, the last administration or two, but we could not get any support from the administration. Now you do support it because that creates jobs. That is what you are trying to do down there, and I think that is a good objective.

Mr. RANGEL. Did he mention my name?

Mr. PICKLE. No, I didn't mention your name.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman. I am glad that Texas and New York get along so well.

Secretary BENTSEN. You two leave me out of that one.

Mr. MATSUI. I would like to thank you very much, Mr. Secretary, for your vision and your work with the President on this economic package. I certainly believe that it is well balanced, and it is one that will produce real deficit reduction and at the same time will put funding into areas that have been left unaddressed for a number of years. And I think when we look back on this period if we, in fact, do reduce the budget deficit, it will really be due to your leadership and the President's leadership as well.

I would like to ask, however, a question in the area of the rates. As you know, because of the proposed increase in individual rates, the surtax, the phaseout of the personal exemption and even the Pease amendment, in some cases, the top effective rate could be as high as 43 percent, but more than likely it will be in the range of

40 percent for that one-and-a-half percent of the public that will be affected by the rate situation.

I think the problem, and I don't know whether it was intended or unintended, as a result of that, is that these taxpayers will have a capital gains differential of approximately 12 to 13 percent. As you know, at this time the differential is 3 percent. Perhaps this differential was unintended, or perhaps it was thought out, but it will have consequences as you, when you were Chairman of the Finance Committee and when we went through tax reform, and we all realized.

For example, it might cause an increase in corporate accumulated earnings because it might be better for public corporations not to issue dividends but instead to accumulate earnings so that stock values will inflate and investors would get preferential capital gains treatment. Certainly, the combination of the differential and Mr. Andrews' passive loss relief legislation could end up increasing the probabilities of tax shelters.

I have also heard from constituents that brokers and investors may start shifting assets from taxable bonds to nontaxable bonds and high-risk, high-growth stocks because of this differential. In addition to that, only those that are in the top one-and-a-half percent, those that are above the 28 percent bracket, really will benefit from this. If you are at a 14 percent rate, your rate will be 14 percent whether it is ordinary income or capital income. If, in fact, we do want to have a capital gains differential, perhaps we should look at an across-the-board exclusion, say a 14-percent exclusion, or whatever it may be.

I do understand that one of the counter arguments that might be made against what I am suggesting is that because at death assets receive a stepped-up basis, therefore, keeping a lower 28 percent capital gains rate makes people more inclined to sell their assets while they are living. But if you raise the rate too high then, of course, they are going to hold their property until death, and then their heirs will get the stepped-up basis. That is a legitimate argument.

At the same time, I can't imagine it is our intent or the intent of the Clinton administration to accidentally back into a 12 or 13 percent capital gains differential for the top one-and-a-half percent of the American public without giving this a lot of thought. I think we really have to discuss this, because I know that this is a topic of some interest among members of this committee and certainly members of the Finance Committee.

Secretary BENTSEN. Congressman, this was done with intent and an understanding that it would probably encourage a shift toward investment. And that is the purpose of it, that it would cause an increased interest in equity investments that would help start businesses and create jobs. That is fully understood.

There is another point that economists argue, that at some point you get the locked-in feature more. And some would argue that you are near that breaking point at 28 percent. So that is another thing under consideration, that you lose revenue if you increase the capital gains tax rate too high. Assets get locked in, but there is an absolute and full intent to try to encourage investment more.

Mr. MATSUI. Interestingly enough, only four or so years ago, Secretary Brady said that the lock-in occurs at 23 percent. I suppose additional studies have been done since that time, but it would seem to me, then, that we are going to probably have to look at other areas of the code, and perhaps you and your staff have done so, because reestablishing the differential will cause a ripple effect within the Tax Code, and within the economy. Behavioral changes undoubtedly will occur. I am just concerned that we may go back to the pre-1986 Tax Act situation where we rewarded not investments but gimmicks, and enabled people to use the Tax Code to perhaps avoid taxation by changing income characterization from ordinary to capital.

Secretary BENTSEN. Well, we are going to try to stop abuses if we can. But I seem to remember you have had an interest in capital gains, and you have supported something on a version of the Bumpers Bill, as I recall.

Mr. MATSUI. Our bill is——

Secretary BENTSEN. Or small business.

Mr. MATSUI. Our bill is much different than this. We put a lot of provisions in there, as you are aware, which would make sure that we don't fall into the trap of creating tax shelters. And it only applies to direct stock investment, and the proposal is specifically targeted.

But the effect that we have in the administration's bill would have a much broader effect. Real estate and collectibles would apply. I think, even under the most extraneous circumstances, when we discussed the bill in 1986 we didn't want these types of things to occur. That is why I think this really has to be examined and looked at carefully.

Secretary BENTSEN. Thank you.

Chairman ROSTENKOWSKI. Mr. Secretary, I have introduced H.R. 13 and H.R. 17 to simplify the tax laws to make necessary technical correction. Of course, you are familiar with these and other proposals because we worked on them together as we formulated last year's legislation.

Further, H.R. 11, as it was approved by the Congress and vetoed by President Bush, included a number of miscellaneous provisions that are important to Members of Congress. Many of these miscellaneous provisions passed the House of Representatives overwhelmingly in separate bills. Do you think, as the budget reconciliation process evolves, that the administration would be willing to add some or all of this legislation to the package?

Secretary BENTSEN. Well, let me say, first, on the simplification, we certainly did work together, and I want to do everything we can to bring that to culmination as soon as we can, Mr. Chairman.

Now, insofar as individual Member's legislation, I think it is much too early for us to comment on that.

Chairman ROSTENKOWSKI. Well, I just want to point out, Mr. Secretary, that the measures that I am alluding to passed the House of Representatives in some instances with 290 votes, 300 votes, and so the House has evidently overwhelmingly approved this legislation. I just wanted to bring that up to you because when we get in—when we are going to look at your legislation as proposed I am sure that Members will be interested——

Mr. PICKLE. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. We are not talking about just private bills.

Secretary BENTSEN. I understand that.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Secretary BENTSEN. I have been here. I understand.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to have you before the committee. I congratulate you for the package that you brought forward to deal with the economic programs of our country.

I want to follow up on Chairman Rostenkowski's point. One of the centerpieces of the package that you brought forward is to increase public investment, and, of course, public investment is not only done by the Federal Government but by State and local governments. I was very pleased to see as part of your package the permanent extension of the mortgage revenue bonds and the small issue industrial development bonds.

But there were other provisions in H.R. 11 that the Chairman just alluded to to make it easier for State and local governments to use tax-exempt financing, particularly on some of the arbitrage rules, and I would hope that, as we go through the process of working the package, that we look at improving it, particularly in this area, to include the provisions that were previously passed in H.R. 11. I would welcome your comments on that point.

Secretary BENTSEN. Yes, I particularly remember getting into the arbitrage problem and some of the concerns, and we would be delighted to take a look at them. I can't make a commitment without further studying them.

Mr. CARDIN. I appreciate that.

I think that we can enhance some of the provisions that you are trying to do to encourage additional public investment. The Anthony Commission that worked on this, as you are aware, pretty much marshaled all the different forces to try to come forward with reasonable suggested changes.

I would also like to at least get your comments on the concerns that have been expressed by the Chairman on the incremental investment tax credit and other concerns about whether we really can enforce what you are trying to do on an incremental investment tax credit. The Chairman mentioned the point about mature companies. The examples have been given about a new company that may be formed as a leasing company for an existing company or a subcontractor for an existing company, and we haven't seen the specific legislation, but I am wondering whether you are equally concerned about how you can enforce an incremental——

Secretary BENTSEN. No question, that is a problem. But we are trying to address that, to ensure that you don't have the transfer of the incremental investment tax credit to a person that really isn't justified in having it. We saw that game played in the past, and we are going to try to protect ourselves to the extent we can on it.

The other point is, with a short period like that for a couple of years, that doesn't give them much chance to start forming a bunch of subsidiary corporations and playing games.

Mr. CARDIN. I think they have already started to work, so we will be curious to see how your legislation will address that.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Payne will inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman. Thank you, Mr. Secretary, for being here, and thank you very much for the bold plan that you have put forth and President Clinton has put forth, one that certainly many of us feel very, very good about and intend to support very fully.

I also want to commend President Clinton and you and Secretary Altman for the work you are doing even today on the credit problem. I think there is no way that we can have the kind of recovery that we need to have and have economic growth unless we deal with credit. And I am particularly pleased from what I have read in the overview about the changes that may occur as it relates to the real estate industry, and the things that need to have some obstacles removed. I commend you for that.

Yesterday we had our OMB Director, Leon Panetta, here and Dr. Tyson, and I asked them, generally, about the overall tax situation as it related to businesses. And as you look at the increase in corporate income tax and the Btu tax and as you then look at the investment tax credit and the capital gains opportunities for small businesses, were there things that had been done by them to look at these things comprehensively to make determinations about how they would affect business? And I understood from Dr. Tyson that they had been done on a macroeconomic basis. And the conclusion was that, in total for the country, it would create jobs and, in fact, as many as eight million jobs. She discussed that yesterday, but she was just beginning to look at various industries.

You spoke earlier about the impact of the Btu tax on the aluminum industry. My question is, has the Treasury Department looked at various industries, at how they would be affected by this package? And, if so, is that information available that we could—that could you share it with us so we could look at that as we think about these tax policies that we will be having to make decisions by?

And, secondly, if they have been looked at, are there industries that you have concerns about as it relates to economic growth and job growth as we look to the future?

Secretary BENTSEN. Congressman, we don't have details on all the industries—we don't—but we have chosen some where we thought that there was a potential problem. We did examine the aluminum industry because we know it is energy intensive in its product. So while some have been picked out and studied, we don't have information across the board.

Our analysis has been macroeconomic, in general, as Dr. Tyson was advising you.

Mr. PAYNE. Well, do you intend to pursue that for other industries or do you think you have sufficiently looked at those industries that are the critical ones and that you made the determination that, because of the way you have structured the tax, the amount of the tax and the fact that it is phased-in over time that the market economy will be able to absorb that sufficiently so there

won't be any downturns and there won't be job losses as a result of some of those tax policies?

Secretary BENTSEN. Well, we have done some things there. R&D, for example, we know that that, obviously, is going to help high tech, it is going to help research-intensive companies, and that is a plus for that segment, those types of companies. We know that the ITC helps companies in their regular tax. We know that the AMT and what we do there helps capital-intensive companies. And where you had, in effect, three computations as far as depreciation, we get it down to one, and then we shorten the depreciation period on that one, too. So for capital-intensive companies that is a major plus. It will be quite effective for them.

Mr. PAYNE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Secretary, I noted with interest your chart comparing our tax burden with some of our international competitors. I would only note that some of those nations have seen the errors of their high tax, big-government ways and seem to be coming back toward our way of doing business. I would hate to see us pass them in the night going the other way.

I am from one of your neighboring States, Louisiana, and I go home almost every weekend to talk with my constituents. In talking with them about your package, the most often-heard comment is, we want spending cuts first and taxes later if necessary. In talking with my colleagues, it seems that that is what they are hearing at home, too. Yet in your testimony spending cuts are roughly equal to tax increases only in the fifth year.

If one looks at the effect over the first five years of the plan, you see that the plan is heavily front loaded with tax increases and not so much with spending cuts. So it seems to go against what my constituents are telling me—that they want spending cuts first, taxes later if necessary.

The House and Senate Democrats, I understand, have said something similar to the administration. According to one report, the Senate Democrats are going to ask you to include an additional $90 billion in spending cuts in your plan.

I am just wondering at what point do you think we come up with a plan that is too big—whether it is composed of spending cuts or tax increases—in terms of its effect on the economy? Can you accommodate another $90 billion in spending cuts without reducing the tax increases? Have you considered reducing the tax increases in favor of more spending cuts?

Secretary BENTSEN. Well, part of the problem, Congressman, is when you are talking about spending cuts and trying to put them into effect and trying to put them into effect immediately. For example, what is happening in defense, the cuts that are made there. I think that is as far as we ought to go. And we are talking about, as I recall, $37 billion in cuts in defense by the year 1997. You go more than that, you are going to have that many more people out looking for jobs.

It has taken a while for this defense conversion to take effect. It doesn't happen overnight. So if you try to do much more in spending cuts right up front, dramatically, at the beginning, I think you

are more in danger of delaying this recovery and, in addition, putting a lot more people out on the streets. And that gives me great concern.

We are talking about laying off of employees—of 100,000 employees in the Federal Government over these three or four years now, and yet we want to do it by a managed attrition. That seems, certainly, the more humane way to do it, and a better scheduling where we can make the changes that are necessary in our tables of organization and our administration and our job descriptions and the rest of it. So we gave consideration to the other but felt that, insofar as any dramatic dislocation, we just shouldn't do that.

Once we get out to the year 1997, and if you bring about some more of these cuts we are talking about, whether they are cuts that the Budget Committee is talking about or something more insofar as the Senate, I think that you will see the 50/50 ratio move to the other side. The ratio of the cuts and the reduction of spending will probably be more than the tax.

Mr. McCRERY. Well, just let me give you some figures so my constituents will know what this plan is. For the first five years of implementation, if you change just the tax increases that the CBO and Joint Tax Committee have indicated should be scored as tax increases and not as spending cuts, move that to the proper side of the ledger, then you get about 70 percent of the deficit reduction package coming from increased taxes and only 30 percent from spending cuts.

That is not what my constituents are telling me they want, and I hear you saying they can't have what they want, that we can't cut spending enough to get back that kind of reduction. I would submit to you that a number of us on this side of the aisle and perhaps some on your side of the aisle will be coming up with some suggestions for areas that can be cut, and the outlays will, in fact, give us some numbers that will reach those deficit reduction figures that you would like to reach.

Secretary BENTSEN. Congressman, we would be pleased to consider them.

Chairman ROSTENKOWSKI. Mr. Hoagland will inquire.

Mr. Jefferson will inquire.

Mr. JEFFERSON. Thank you, Mr. Chairman.

Mr. Secretary, Like so many on this committee, I have witnessed your long and distinguished career of public service. And I think the President showed great wisdom in offering you the position you now have, and you did us a great service accepting it.

Secretary BENTSEN. You are very generous, sir.

Mr. JEFFERSON. I am very pleased to be a part of this hearing and to hear your testimony and your answers to the questions. I fully expect to support this package. I think it is balanced and fair. There are some things, however, that I do have some questions about, that I hope in the course of things we can straighten up, if possible.

Now, according to figures compiled by the Travel and Tourism Administration of the Commerce Department, tourism is now America's third largest industry. In my city, New Orleans, it is the first, and in my State it is the second to oil and gas. It employs

six million people directly and millions more indirectly and has a payroll of almost $100 billion.

Travel and tourism is labor intensive, yielding a strong return in jobs created per dollar invested. In fact, our records show that for every $15,000 invested, a job is created. And so expenditures on meals and entertainment for business travelers away from home seems to have the effect of being an economic stimulus by creating permanent jobs. Noteworthy also in its context is the fact that virtually every major convention center in the country is located in an urban center, like my city.

Wouldn't the effect of raising rather than lowering the deduction for business travelers create more job opportunities for inner city residents who were left behind by the economic policies of the past 12 years rather than the way this policy seems to be suggesting by the package?

Secretary BENTSEN. Well, when I think of the attractiveness of New Orleans—I don't think you are going to have any problem insofar as entertainment or conventions. I have been there many times myself and shared in its hospitality.

I can also say I can recall when we reduced the expense allowance on meals and entertainment to 80 percent, the prophecies we had of what it was going to do to restaurants, to entertainment and the rest just didn't happen, and people kept on entertaining, and they kept on eating.

And I know that when you are talking about taking people out to entertain them that part of that is personal consumption, and it has always been a problem, an issue trying to decide what should be disallowed in that regard. We believe that the 50/50 allocation brings out a fair balance in that, and I am optimistic that it is not going to see any reduction insofar as tourism to New Orleans or the use of your convention centers. I think those will continue on just as they did when we reduced it to 80 percent.

Mr. JEFFERSON. Well, I hope you are right about that, and I hope that you will be open and the administration will be open to maybe hearing a few other arguments along those lines as we proceed with this process.

Secretary BENTSEN. Congressman, I am sure we will hear a lot of those arguments.

Mr. JEFFERSON. Yes, sir. I just hope you will be open to think about that particular one. That is really important to us.

One other one that is important to folks who represent areas like mine—there is no particular one area like mine, as you know, but who represent cities with transit authorities—I am concerned about the effect of the Btu tax there for the use of fuel for gasoline and other fuels. There are exemptions in the law that permit local governments and State governments and nonprofits not to pay the tax. Is there a similar exemption or will there be with respect to the application of the Btu energy tax?

Secretary BENTSEN. I must say I have not gotten into that detail. I know what we are talking about insofar as the extension and the added appropriations for mass transit and for highway and bridge construction, that we are pushing for that, and I would hope that that would counteract the problem, but I would be delighted to look at the details.

Mr. JEFFERSON. Yes, I would really appreciate that if you would. I know there was some talk early on about the oil import fee, and I know there was a great deal of discussion about that and a great controversy about it, but was that seriously looked at by the administration? And if you can tell me what are the shortcomings, what would prevent the administration from embracing it as an option?

I know we have problems in the northeast with oil usage and all that, but we could solve those with the various credits and breaks that we could have the imagination to create. Is there any reason why that wouldn't be a way to look at dealing with some of these critical issues?

Secretary BENTSEN. Congressman, we looked at an oil import fee, and we knew the kind of problem we would have in New England with that one. We looked at a gasoline tax, and we looked at problems of States like yours and mine that depend a lot on the automobile and how that would hit us in an uneven way as compared to the rest of the country. We looked at a coal tax, carbon tax, and we looked at what that would mean to States that are major producers of coal.

And, finally, we came up with one in the Btu tax that we thought would fight pollution, would have a fairly balanced effect across the regions of the United States and, at the same time, bring about some conservation.

When we talk about reducing the imports of oil by some 350,000 barrels, that is a plus. Today, we are importing about a billion dollars worth of oil a week. So we do bring about some conservation in trying to help in that regard with this Btu tax, but, as far as having an import fee and doing it that way, I don't think that can come to pass.

I must tell you, Congressman, I sponsored one of those one time in the Senate. I did not get 51 percent.

Mr. JEFFERSON. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Reynolds will inquire.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Mr. Secretary, thank you so much for your testimony today, and I was really looking forward to it.

Two different areas—one area I want to follow up on, yesterday's questioning of Director Panetta. This has been a lot of talk about the so-called sin taxes, meaning taxes on alcohol and tobacco, and—as they relate to the revenue as it relates to health care. Indeed, the First Lady was quoted yesterday in an interview with the Associated Press as saying such taxes were a good revenue source because "those are health related."

I have introduced legislation that would effectively double the excise tax on firearms, and people have tried to compare that to, if we are going to have sin taxes, let's also raise this excise tax so we can have money to help go to hospitals to treat uninsured gunshot victims. This tax has raised quite a bit of money since it was first implemented in 1940. Last year, there was $123 million.

Are these kind of new approaches and different taxes something that you will be willing to consider?

Secretary BENTSEN. Well, let me say that that is new, as far as I know. And one of those things that we will be pleased to study—we will put it on the list to study it, but I have not addressed that one.

Thank you for your contribution on it.

Mr. REYNOLDS. Thank you, Mr. Secretary.

My other question is in the area of enterprise zones. I am glad to hear you mention enterprise zones, and I believe the concept, implemented correctly, could provide tremendous benefits to communities and neighborhoods that I represent. While recognizing the details of the proposal are still being worked out, could you provide some indication as to how many zones the administration is considering?

There was some confusion during yesterday's testimony that the number might be 30 or 50. My colleague, Congressman Rangel, mentioned that he had heard the number was as low as 10. Can you clear up this confusion or do you have any idea as to how many we are talking about here?

Secretary BENTSEN. Let me add to it. We started out talking about 50. I have heard 10, I have heard 150. We are obviously working on it and haven't come to a conclusion. We are pleased to have any input you might have on it.

Mr. REYNOLDS. Has there been any thought on allocation? How far are we on this? Is this something we are just sort of talking about on the surface?

Secretary BENTSEN. No, no. We have some proposals, as we had in the last tax bills last year. Those are things you start out with. You look at those and then you say, now what can we do to improve on that approach? And that is what we are doing.

Mr. REYNOLDS. I have seen them in H.R. 11. I saw them in—also in H.R. 13.

Secretary BENTSEN. I was very much involved in that, as were the members of this committee.

Mr. REYNOLDS. Thank you very much, Mr. Secretary.

Secretary BENTSEN. Surely.

Chairman ROSTENKOWSKI. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

The Clinton proposal will limit meal deductions to 50 percent. Does this mean that employees of tax-exempt organizations, including the Federal Government, will have to include the expenses they incur, but for which a deduction is denied, in their gross income?

Secretary BENTSEN. I don't think we have addressed that in the proposal at all.

Mr. HANCOCK. But it would seem to me that, for fair treatment of business deductions, anybody that is traveling at government expense should have to pay the tax on their meals that are paid for by the taxpayers while they travel.

Secretary BENTSEN. You are talking about an imputed income there. Is that what you are talking about?

Mr. HANCOCK. Yes, sir.

Secretary BENTSEN. That is an interesting proposal.

Mr. HANCOCK. Thank you.

Chairman ROSTENKOWSKI. Mr. Kleczka will inquire.

Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Secretary, is there any economic analysis available within the administration as to what effect the increase in the inland waterways fuel tax from 19 cents per gallon to $1.19 cents per gallon will have on the goods that use the inland waterways?

Secretary BENTSEN. That is a use fee, as I understand it, that OMB is proposing, isn't it? At Treasury, we don't have that study. You would have to talk to OMB.

Mr. COYNE. My concern is that—particularly local communities who depend on the waterways for their local products—would be placed at a competitive disadvantage.

On another subject, one of the advantages, as we know, of the value-added tax is the relative simplicity of applying it and making it border adjustable. The advocates of a value-added tax always make that point that it is easily made border adjustable and, as a result, helps our companies in the competitive situation relative to foreign producers. Is there any consideration to make the Btu border adjustable?

Secretary BENTSEN. No, we have not given consideration to that.

Mr. COYNE. And that is not likely to happen?

Secretary BENTSEN. That is not anticipated.

Mr. COYNE. Thank you very much.

Secretary BENTSEN. Surely.

Chairman ROSTENKOWSKI. Mr. Neal will inquire.

Mr. NEAL. Thank you, Mr. Chairman.

Let me applaud the appointment of Secretary Bentsen as well. I have been impressed by his career achievements for many years. The Individual Retirement Account—I filed my own version last year—was inspired by the version that you submitted as a member of the legislative branch of the government—and I haven't heard you say anything about it as a member of the executive branch of the government this morning.

I think we would all agree that a number one economic problem that America faces is our low national savings rate. Mr. Pickle and I have been conferring on this issue, and we are kind of awaiting your suggestion at this point ever so hopeful that you will offer the same standard that you did as a Member of the Senate and Chairman of the Finance Committee and swiftly move forward with an Individual Retirement Account proposal.

Secretary BENTSEN. Congressman, that subject is one that is dear to my heart, as you well know. And when you get as long in the tooth as I am you begin to draw from your IRA account, and so I am now benefiting from mine.

The choice is how you take care of savings in the country. One way is by individual savings. And they certainly need to be increased in this country where they are about half that of the Germans, about a third that of the Japanese. The other way is by cutting back on the public deficit. That is savings, too. In this instance, that is what we have chosen to do, and we have gone all out to cut back this budget deficit.

So, at this point, I have a choice amongst options and did not feel that IRA was something that could also be added to the package. And that was not a casual decision on my part. It was one I felt

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that was a necessary result. That does not mean I am still not enthusiastic about IRAs because I am.

Mr. NEAL. It would seem to me that it offers an ideal opportunity to the middle class to put aside some money on an annual basis for savings. And if that is the notion that we would like to get to, in conclusion, it seems as though we ought to proceed down that path.

But let me, after I made that pitch, let me ask you another question. I appreciate the sentiments you offered this morning about the different regions of the Nation making different specific sacrifices as the plan unfolds, and I am largely supportive of the package that you and the President have offered, but I have to make an earnest case for what the tax does to oil in New England.

And I know that you have gone down this road before in your previous life as Chairman of the Senate Finance Committee, but I once again have to point out very strongly that the taxes offered in your current package on home heating oil in New England disproportionately hurts the poor. I know you are going to suggest the trade-off is the tax credit that has been offered and all, but I just have to come back to that statement.

I am in a district that is adjacent to the late Silvio Conte, and, as you know, he had a field day for many, many years over this issue, and I feel compelled to speak with the same strength that he did on this issue.

Secretary BENTSEN. Let me say that if you get on a per capita basis, the impact is more on New England. If you get on an economic basis, it is less in New England because you have a higher average income than other parts of the country.

We put in LIHEAP, and we boosted it substantially to try to help in that regard for those of lower income. We did that also for the earned income tax credit, and we also did it for food stamps to try to see that that balanced out. So that is the way we tried to average it out across the country.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mrs. Johnson will inquire.

Mrs. JOHNSON. Thank you, Mr. Chairman, and welcome, Mr. Secretary. It really is a pleasure to have you, and I commend you on a really excellent presentation.

I am also very pleased with the leadership that you are providing on the issue of credit crunch, and I hope that you will be more successful than your predecessor in getting the relevant agencies to work together to actually make the agreements that are necessary to effect the regulatory system in the way that you propose.

Past efforts have not been able to get the FDIC, the Controllers Office, and the other critical parties to agree and go forward. So I wish you well. Solving that problem would do more to stimulate the economy in the northeast than anything in this package or anything any of us will do in the next 6 months or a year. Given the enormity of the economic problems of Connecticut, I do hope that that can be moved forward with some real speed.

Second, I want to raise some questions about the tax proposal that you have put before us. Martin Feldstein, I think it was, in an article recently suggested that if those affected by the higher tax rates sheltered just 10 percent of their income or changed the

way they managed their income so 10 percent less of their taxable income was taxable, that in fact, you would not raise any of the new revenues you are projecting. Of course, if that happened, the impact on deficit reduction would be staggering.

It seemed to me, from the examples that he gave, that he made a very good case. I want to ask, did you make any assumption of behavioral changes in your projections?

Secretary BENTSEN. Yes, we very definitely did. Treasury did that. There is some disagreement, obviously, between Joint Tax and Treasury, and it has been traditional when you are talking about higher income, and the behavioral response was very definitely factored into it.

Let me say, insofar as the first part of your statement, that we have been very pleased with the kind of response that we have had in the way of cooperative effort on the part of the FDIC, the Comptroller of the Currency and the Federal Reserve insofar as the credit crunch, and the President will be announcing that within a couple of hours.

Mrs. JOHNSON. When he announces it, will he actually announce an agreement among those agencies as to how it will be implemented and precisely what the new regulations will be?

Secretary BENTSEN. We don't have the regulations yet. That will take a bit. But it will be a regulatory effort because we can do that expeditiously.

Mrs. JOHNSON. Well, I look forward to that. Thank you.

I want to support the comments of my colleague from the other side of the aisle on New England's concern about the impact of the energy tax. To tax oil twice as heavily as natural gas will put a very heavy burden on many who depend on home heating oil and also many small businesses because they are in areas where there is no natural gas. A lot of New England is very rocky, and there is not access to gas, so there is not the possibility of switching.

I am very concerned about the impact of the energy tax on our competitiveness because the margins of profit are very thin and competitiveness is a very tightly contested issue moment to moment, product to product, week to week, and so on.

It is true that Europe taxes gasoline far more heavily than we do, but they tax people who buy gasoline for their cars. My understanding is, and I believe I am correct in this, that there is no tax on manufacturing fuels, so that the increase in fuel costs for our manufacturers is a far heavier burden than that as Europeans. So, while they tax energy more heavily, they tax energy differently than we do, and it has less impact on competitiveness.

Secretary BENTSEN. Congresswoman Johnson, I have been advised very strongly that their tax on energy, too, is substantially higher than ours.

Mrs. JOHNSON. Well, I certainly would like to get that straight because there seems to be really contradictory information. Thank you.

Chairman ROSTENKOWSKI. Mr. Andrews will inquire.

Mr. ANDREWS. Thank you, Mr. Chairman.

Good morning, Mr. Secretary. It is an honor to have you here before our committee.

I would like to ask you to address your thoughts for a few moments about the energy component in the bill. I have a specific question relating to a potential tax credit for industrial use by a manufacturing company or manufacturing use by large corporate companies. Is there a possibility for a tax credit to alleviate the impact of the Btu tax?

But, broader than that, I would really like you to address what you think the impact of this tax is going to be on the producing States. I have heard you many times recite the statistics concerning States like Texas, Louisiana and Oklahoma who have been the hardest hit in the 1980s and first part of this decade. Adding together all of the job losses in other troubled industries does not come close to the jobs affected in the energy sector.

How does this tax affect an energy strategy? What are the specific steps you think the administration and the Congress need to take to address a tougher, more aggressive energy strategy for this decade and the next? What do we do to put people back to work in the oil patch, and raise the rig count and encourage domestic production?

Secretary BENTSEN. Well, one of my objectives is to get this economy moving again, and what we are talking about with the investment tax credit, what we are talking about for small business on capital gains, what we are talking about with getting the deficit down and reducing interest rates, those are things that ought to get this economy moving better than it has in the past.

Now let's get specifically to oil and gas in the State of Texas, Louisiana, other oil States. Every barrel of oil that is raised in those States is going to be sold. The impact will be on imported oil, and that is where we anticipate about a 350,000 barrel reduction.

What you are going to see also is an increase in the use of natural gas, a cleaner burning fuel, one that we have an abundant supply of in the United States which will help reduce some of the dependence on foreign oil and, in turn, add to our balance in payments and trade. So, overall, I don't see those energy-producing States in oil and gas affected in a way that will be to their disadvantage. I don't believe that.

Mr. ANDREWS. Compared to other energy taxes like a gasoline excise tax, do you see the Btu tax as a less onerous tax on the producing segment of our economy?

Secretary BENTSEN. I think you have got a much more even distribution across the country from a regional standpoint, and I think the impact will be quite modest.

Mr. ANDREWS. One of the things people say about the gasoline excise tax is the machinery is already in place. It is an easy tax to use for generating money. Critics say that the Btu tax is complicated, and troublesome. It is hard to know what the real impact on the industry will be. What are your thoughts about that?

Secretary BENTSEN. Well, I think that you can't overcome the regional disparity and impact when you are talking about a gasoline tax, talk about the traveling salesman, talk about the fellow that has to drive a long ways to work. That is a great distortion in the way it affects them. That is why we did not choose that one to be the primary emphasis.

But could I make the same statement about coal States? Could I talk about New England as these folks have been talking about heating oil? So it has not been an easy thing to try to see that we do it in as equitable and an evenhanded way as we could across the different regions.

Mr. ANDREWS. One more question, on a different subject.

I have worked for several years on a passive loss bill to affect real estate professionals. That bill has been modified, changed and narrowed in its scope to really focus on those in the profession of real estate business. We had a large majority of Members of the 102d Congress that supported that measure. It is now in the President's proposals. Do you believe that this bill will help the economy? Is it in there to act as a stimulus to our economy and is it important that it pass?

Secretary BENTSEN. I certainly do. I think it will be a stimulus. I think what you have is real estate that is in a very serious way, from an economic standpoint. I believe that when we are talking about passive losses for people that are truly in the real estate business, we are putting them on the same basis as other businesses and restoring that to them, and I think that is of help.

I think what you are going to see and the way of what the President proposes this afternoon for the banks and the loosening of some credit that that, too, is going to be very helpful to the real estate business.

Mr. ANDREWS. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Lewis will inquire.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Secretary, I want to welcome you here today. It is good to see you. Our President could not have made a better selection for the head of the Department of Treasury. Our taxes and our tax system are in good hands with you as Secretary.

Secretary BENTSEN. You're very generous, sir.

Mr. LEWIS. I said, Mr. Secretary, I think as a Nation and as a people we are more than lucky, we are blessed to have you as Secretary of the Department of Treasury. I want to say from the outset that your proposal, your package, will have the support of this Member because I think it is an honest and good proposal.

Secretary BENTSEN. Thank you.

Mr. LEWIS. I just want to get your comments on what your tax proposal would do to aid our cities. Our cities are the heart of our Nation. Our cities are in trouble. Our cities are in need.

We have crime, and we have a great deal of violence. There is a need for affordable housing. The infrastructure is falling apart in most of our cities. We need to fix our roads and bridges. We need to clean up our water. We need new sewers.

For this Member, I would like for you to elaborate on how your proposal will affect cities like Atlanta. It is not a big city like Dallas or Houston. It is a small city in a small southern State.

Secretary BENTSEN. Did you say Atlanta? You wouldn't pull my leg, would you?

Mr. LEWIS. I wouldn't do that, Mr. Secretary.

Secretary BENTSEN. It is a beautiful and a very large city.

But what we are talking about in that doing the things you were talking about, on roads and bridges, emphasizing that, getting the

infrastructure bolstered and the creation of jobs that go with it, trying to see that we take 700,000 youths off the streets this summer and give them jobs for the summer and creation on an annualized basis of some half a million jobs, bring about enterprise zones that will be helpful to the most aggrieved part of our urban areas to see what we can do to turn those areas around. Create new jobs, tax incentives to invest in those areas, to do what has to be done insofar as community banks in those areas, trying to see that they make the kind of investments in those areas that are needed to help bolster them.

Those are all pluses aimed at urban areas. Trying to be of some assistance to them, talking about Head Start, fully funding Head Start. You know, for us to have epidemics in measles in this day and time is just ridiculous. Talking about the immunization of children, spending a substantial amount of money to get that one done, you get a payoff of $10 for every dollar you spend in that regard. All of those.

Mr. LEWIS. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman.

Mr. Secretary, welcome. I want to applaud you on the presentation of the President's proposal, an excellent vision, and I do not intend to challenge it today because there is a problem that is developing outside of the stimulus package which I think needs your immediate attention, and I wanted to take my time to focus you on it.

I realize that you have been involved in much weightier matters, and this is probably way down on your screen right now, but it is a little piece of a potentially very big problem in grain and soybean-producing States. Are you aware of the Supreme Court decision on *Arkansas Best*? Are you familiar with that?

Secretary BENTSEN. I have not looked at it recently.

Mr. GRANDY. Okay. That may be part of the problem right there. Let me just try and take my time to explain it to you, Mr. Secretary, because this is a problem that involves a potential collision between the IRS and the Department of Agriculture. The casualties will probably be in Iowa, Illinois, Kansas, Missouri and some of the large, as I said, grain and soybean-producing States.

Basically, the Supreme Court has ruled that, as relates to hedging and buying options on the futures market, particularly the Chicago Board of Trade, the gains are treated as ordinary income and taxed immediately, while the losses are treated as capital losses and can be only offset with capital gains. In effect, what is happening here is the farmer is basically getting the worst tax treatment for both gains and losses.

Now the reason this is significant at this juncture is the Department of Agriculture, with the full support of Congress, has initiated a thing called the options pilot program which is designed to encourage farmers to use the Board of Trade to hedge against risk. The options pilot program is going on in various States including my own.

This is a letter that was sent to Chairman Rostenkowski by the chairman of the Agriculture Committee, Mr. De la Garza, and the subcommittee chairman of jurisdiction, Mr. English.

The letter in part states that they want the chairman to be aware of the real and potentially destructive impact IRS policy is having on an agricultural program designed to demonstrate innovative and market-oriented approaches to the Nation's agricultural policy and on the efficiency and effectiveness of hedging markets.

In the greater context, your administration is proposing significant reductions in agricultural subsidies which I must tell you, as a member of a large agricultural district, I will support because I think it is fair to systematically reduce some of those subsidies. But if you are intending to transfer people to the market and to a form of private insurance, which the Board of Trade represents, as opposed to public insurance, and you are hoping through the Uruguay Round to become more based on agricultural prices from a foreign market as opposed to a domestic government source, this pilot program is terribly important. A confusing or, in this case, kind of punitive IRS policy will not achieve the goal that I think we all want, which is to make farmers more responsive to the market and less responsive to the government.

Now my understanding is this can be fixed two ways: A ministerial act by yourself or your subordinates. Of course, one of the problems I have had is there aren't many subordinates there for me to communicate with so I took this time today. But this is, obviously, something that would fall under the IRS commissioner, whoever that person may be, or it can be done legislatively.

Now I would prefer this to be done by you and with you because I think, although there may be some disagreement on how the capital losses and the ordinary gains might be worked out, the decision is very important and will help this pilot program go forward.

I realize that you have got 100 things to do that are significantly more important to you than this. But, based on the communication I am having with constituents and members of the Agriculture Committee, this is a potentially very big deal for us, Mr. Secretary, and I think an initiative that this administration should encourage, particularly in light of their request to reduce government subsidies.

With the Tax Code, in my view, standing in the way of a market-oriented agricultural policy, can we get some help from Treasury and/or IRS, either ministerial or supporting a legislative fix which might be attached to the stimulus package?

Secretary BENTSEN. Congressman, as I listen to you, it certainly is a genuine problem. I would also assume, as I evaluate it, that it would have significant revenue implications, so, obviously, it has to be addressed.

Mr. GRANDY. Well, it has significant revenue implications for farmers in the short run and significant implications to the government in the long run. Because, if they can't use the Board of Trade creatively, that will probably oblige them to come back to the government for price supports.

I think your colleague and my colleague, Senator Dole, would concur with this, too. I am not speaking for him because we have not discussed this, but I know this is a big deal in Kansas as well

as Iowa. I just guess what I want from you, Mr. Secretary, is some kind of signal that your department will be responsive at least in communicating with my office and the principal players here in trying to get this worked out so we don't have to try a legislative solution that may come too late.

Secretary BENTSEN. Congressman, my staff advises me they are aware of the problem, and let me dig into it and have a better understanding of it.

Mr. GRANDY. Well, I appreciate your attention to this, Mr. Secretary. As I say, it is not as, perhaps, as visionary as some of the stuff you have got in your package, but it is very much in the sights of a lot of farmers and grain producers in my area.

Secretary BENTSEN. I can understand that.

Mr. GRANDY. Thank you.

Chairman ROSTENKOWSKI. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. Secretary, welcome. It truly is wonderful to see you here in this capacity. I think some people have commented on the lack of contentiousness, the atmosphere within this hearing. I think part of it is respect for you, deeply felt respect for you.

I think it is also because the administration's plan is basically right. It broke the ice, and it is trying to head in a new direction in terms of fiscal responsibility. So let me just, if I might, within that context, ask you or comment on just a couple of things quickly.

Mr. Matsui referred to the capital gains differential, and it would now be quadrupled, in essence, and I would hope that, as on other things, that the executive and legislative branches could work together to inquire into this and to make sure in its present form it is the best we can do. Maybe it is.

But I think it does raise questions of potential sheltering, and there may be alternatives that would diminish that likelihood. For example, some kind of an exclusion across the board which would also make the capital gains differential available to everybody and not simply the wealthiest of citizens. For example, why is the surtax essentially exempt from capital gains? What is the policy reason for that?

Secretary BENTSEN. Well, once again, as I have stated, what we are trying to do is encourage investment which we think will create jobs and help us get small businesses started. I must say that when we talk about the differential, it is less than half what it was before 1986. We are trying to get people to not just look on interest earnings but to make that kind of capital investment that we think is important in the country.

Mr. LEVIN. Well, perhaps this is the wisest course. But I hope we can work together to take a look at it, and I know if there is any better way that you would be at least receptive to looking at it.

Secretary BENTSEN. Certainly.

Mr. LEVIN. I think also, on the ITC—I am one of those who sponsored an ITC with an incremental attribute to it, but it is a bit troublesome, and it is not clear how the incremental aspect really works out. I think you have somewhat moderated it with the way you handled the minimum tax so that there is a more even distribution of taxation, for example, within the manufacturing sector,

but I think it is still true that the ITC, the way it is presently proposed, will not be available to a lot of the subsectors within manufacturing which, perhaps, we want to stimulate. But, again, we will need to look at that.

One last point. I really hope that the Treasury Department under your leadership will look at trade policy in a broad way, including its impact on investment flows. I think under some of your predecessors that wasn't true. And you have a very major role, appropriately, to play in trade policy, and I hope that your department will work with us to take not a kind of mechanical look but a broader-based look at what particular trade policies might do to investment flows. That is true of NAFTA. It will be true of GATT and other major trade matters.

Secretary BENTSEN. Well, thank you for that, and we will.

I would say, of course, the major responsibility and jurisdiction is with the trade ambassador, but what we can do to supplement, bolster and help—and in all candor, because of my great interest in that area for a long time, I can't help but offer some advice.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I commend you and the President for your leadership on what you have done in just a couple of weeks in terms of leading this country forward and in facing these problems.

A couple of positive reinforcement statements, I guess. One is on the credit crunch. Regulatory reform is necessary, it is timely, and I am sure it would be well received here in the Congress.

Second, I want to support what Congressman Neal said about the IRA programs. There is a recent study out by Merrill Lynch which shows that my generation, the baby boomer generation, is only saving for their retirement at about one-third of what your generation was saving for. So as we, as a policy, start taxing and doing things on the social security side, what we do in private pension sides and saving sides for retirement becomes even more critical, I believe.

The third item, it is my understanding that Treasury is conducting a study on refinancing the debt in terms of bonds and notes, what I am hearing from people when I go home in the District is that though the President's plan deals with deficit reduction, we have got this huge problem with debt reduction. And, in terms of the study, an adviser of mine suggests, well, why don't we dedicate part of the Btu or some other tax to provide a credit incentive for people so that the government could buy back these high interest bonds and notes and that would go to debt reduction? Any thoughts on looking at that in terms of this study?

Secretary BENTSEN. Well, I think what you are going to see in this study will show, and I think will bring some change. It will not be anything radical or dramatic insofar as the sale of securities and trying to take advantage of some of the lower rates on short-term money, but by no means do I want to see us bet the business on it, on rates. I think that would be not very wise.

Mr. KOPETSKI. But this would be to——

Secretary BENTSEN. To cut the debt itself?

Mr. KOPETSKI. To buy back these, to pay them off, to buy back these high interest bonds, let's say, and pay them off early, now, today.

Secretary BENTSEN. Well——

Mr. KOPETSKI. Not just refinance it.

Secretary BENTSEN. Well, I, frankly, have not studied that. You would be paying, I suppose, a very high premium today if you tried to buy those bonds with the higher rates that you have on long-term rates today. You would pay quite a bit over par for those.

Mr. KOPETSKI. All I am asking today is perhaps if Treasury could take a look at actually buying out some of the debt.

Secretary BENTSEN. We would be happy to take a look at that.

Mr. KOPETSKI. Very good.

The last matter I want to ask you about, I sent you a letter a couple weeks ago—I know you are really busy—on the Btu tax on hydropower. You keep talking about every other region in the country, and so we can't forget the States of Oregon and Washington who rely heavily on water running downhill for energy.

And in your statement today you say the broad-based energy tax has three important goals: Improving our environment by effectively taxing pollution, reducing dependence on foreign oil, and cutting the deficit. We in the Northwest, we are ready to go for the Btu tax. We just think that hydro is as close you can come to renewable as there is. And it is clean. It is more efficient than any others. And yet it is going to be taxed at a higher rate than gas or fossil fuels.

And I guess we don't understand—if you say we want to tax pollution, why you are taxing us higher than some of these other forms that do pollute more and are less energy efficient?

Secretary BENTSEN. Let me say one of the very major reasons was because of regional balance, trying to get that. And then I must say when you are talking about hydroelectric power, unlike solar and wind power, it is not totally benign. You have some environmentalists that will argue rather strongly that such dams have damaged the river system, so——

Mr. KOPETSKI. Well, we understand that, and we call that the old hydro that does that, and we have the new hydro that takes into account the fish and other issues.

Our problem in the Northwest is we are looking at a 10 percent to 14 percent rate increase because of the Endangered Species Act, both the fish and the owl issues, because of our drought, because of our growth. And when you talk about a 3 percent hit on the aluminum industry, we are truly talking about something that might put some of these companies out of business.

On one hand, the President a week ago or so says, you know, to Europe, quit subsidizing Airbus, and then you turn around and tax the aerospace industry. They are so reliant on aluminum. I mean, you are penalizing one of the successful industries in America.

So when we look at the feed stock issues in terms of whether for oil we are asking for parity and consistency with aluminum as well. I hope we can work some more on this. It was very distressing news to hear your statement this morning about aluminum and energy.

Secretary BENTSEN. I appreciate your comment. We will be happy to take a look at it.

Mr. KOPETSKI. Thank you.

Chairman ROSTENKOWSKI. Mr. Camp will inquire.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Secretary, my question involves the Btu tax and, particularly, the difficulty it could cause independent power producers who often operate under long-term contracts and who are not able to pass along increased costs for fuel. Do you expect that there will be any clarification or change with regard to independent power producers and the way the Btu tax will be levied?

Secretary BENTSEN. Yes. We are looking at that now, trying to see what we can do insofar as getting the cost of that tax passed on.

Mr. CAMP. What is the nature of the discussions you are having?

Secretary BENTSEN. I don't have the detail of that, but that is the objective that we are trying to bring about.

Mr. CAMP. Thank you.

I also have a question about the estate tax exemption, which I understand is not a part of this package. But there have been numerous stories in the press about possibly reducing the estate and gift tax exemption from $600,000 to $200,000. Are you aware of any discussions in your department with regard to that?

Secretary BENTSEN. I certainly have not heard any discussions on that or any offers on that one. I have heard all the rumors and read some of the stories about the $600,000 exemption being troubled. I have had no presentation on that.

Mr. CAMP. Especially with regard to small business and family farmers, that would be absolutely——

Secretary BENTSEN. I well understand that.

Mr. CAMP [continuing]. Devastating.

Thirdly, my question and comment is about the royalty tax which some are saying would amount to a tax on U.S. technology. It would also increase the complexity of the tax system which I know has been a goal of this committee to try to prevent from happening. Can you give me a comment about the rationale behind that?

Secretary BENTSEN. Sure. It is designed to reduce the current tax benefits associated with developing intangible assets like patents in the United States and then licensing them abroad. So the production pursuant to the intangible asset occurs abroad.

It addresses a tax policy concern as well. Currently, deductions for R&E are taken against U.S. income, and the government then does not pick up the tax in many cases on the royalty income from abroad. This proposal would go part of the way to correcting this erosion to the U.S. tax base.

Mr. CAMP. I am sure in your discussions there have been concerns raised with regard to the effect this would have on particular companies who are licensing abroad and trying to repatriate that money to this country. This tax would be devastating to these companies and, in fact, would reduce employment in the United States.

Secretary BENTSEN. But we don't share that. We don't think that would be the case. I think, when you talk about adverse impact on some of these, the program must be considered as a whole. With the other proposals we stand to greatly benefit some of these com-

panies. The permanent extension of the R&E tax credit, the investment tax credit, those I think will, in many of those instances, be of quite a lot of help to them.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman. I do have a statement I would like to submit to the record as well as some questions for the Secretary.

[The statement and questions follow:]

STATEMENT OF THE HONORABLE BILL K. BREWSTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. Secretary, as one of your neighbors along the Red River, I know that you and I share similar interests to ensure that any energy tax does not disadvantage domestic producers competing against foreign producers. Further, since energy inputs are an integral component of almost every manufacturing process, it is essential to this country's economic recovery that an energy tax does not disadvantage domestic manufacturers. Therefore, in designing an energy tax, we must craft export exemptions and derivatives taxes on imports for very high energy content products. The Administration's initial proposal recognizes the competitiveness concern by exempting non-fuel uses of fossil and alcohol fuels.

Although I believe that any deficit reduction revenue measure should be as broad based as possible, I recognize that the energy sector is clearly targeted as a primary source of revenue. The best way to raise revenues from the energy sector would be a combination of a floor price for oil and an ad-valorem based energy excise tax. I believe this combination would be the least disruptive of inter-fuel competition while imposing the least administrative burden on government and industry. As you know from the work by the Senate Finance Committee on energy excise taxes, a combination floor price for oil and an ad-valorem based excise tax can be designed to provide parity among geographic regions of the United States.

In designing an energy tax, we must ensure that we do not cause a loss of domestic manufacturing jobs, particularly in industries that rely on oil, gas, or electricity for feedstocks. The United States has already suffered a damaging contraction of our petrochemical industry. Non-fuel uses of gas, such as in the manufacture of fertilizers, or oil, such as in the refining of petrochemicals, or electricity, such as in the electrolytic process of producing aluminum, must be exempt from a BTU tax. As a result of the Clean Air Act and numerous other environmental and safety laws, industry in the United States is the most safety conscious and environmental benign in the world. In addition to maintaining jobs in our domestic industry, we have an environmental responsibility to keep manufacturing in the United States.

With any energy tax, and particularly with the proposed BTU tax, key questions revolve around the collection points. Natural gas producers make a strong case that if we levy the tax at the wellhead, they will be prevented by market forces or contracts from collecting what should be a legitimate pass through cost.

Electric utilities generally should be able to pass on a BTU tax that is levied on their fuel at the mine mouth or wellhead without further rate hearings through existing "fuel adjustment clauses". However, the electric utilities rightfully are concerned that if the tax is levied on them as electric power generators, as opposed to levying the tax on the fuel itself, they will be unable to recoup the tax except after time consuming and politically

difficult rate cases before State regulatory public utility commissions.

Similarly, the natural gas transportation and delivery industries cogently argue against the Administration's initial proposal to collect the tax at the point of injection into the pipeline because that would tax transportation charges instead of gas thereby compounding administrative and tax avoidance problems. By applying the tax directly on the ultimate consumer, we can avoid compounding the tax on state gross receipt or sales taxes and avoid payment of the tax on theft, lost and unaccounted for gas, and pipeline shrinkage.

I suggest that the collection point should be as close to the ultimate user as is administratively feasible. For electricity, the tax should be imposed on the sale of the fuel at the point it eneters the utility's system. For natural gas, the tax should be imposed at the point it is delivered to the end user, either the residential consumer or the industrial facility.

A final point, before I get to my specific questions, addresses the BTU tax on oil. I object to the differential penalty placed on oil compared to coal. There is not enough elasticity of demand nor is there adequate fuel switching capability to justify the penalty on oil. If one of the goals of the BTU tax is to reduce our dependence on imported oil, I am afraid that it misses the mark. The incremental oil in the United States' economy is the higher cost production from our domestic enhanced oil production and high cost areas, such as in the deep waters of the Gulf of Mexico or in Alaska. Simply increasing the cost of oil without recognition of the higher exploration and production costs domestic producers bear will not encourage conservation, it will encourage imports of oil from politically unstable regions of the world from producers with much lower standards of environmental conduct.

Again, the collection point for the BTU tax is crucial. The collection point on the oil BTU tax should be as close to the ultimate consumer as possible. At a minimum, the tax must be collected beyond the refinery. Taxing oil as it enters the refinery would hurt the United States' economy by making domestic gasoline more expensive than imported gasoline. The BTU content of a barrel of gasoline is lower than a barrel of oil, so the imported gasoline would bear a lower tax than the proportional share of the tax on a domestically refined barrel of gasoline.

My specific questions are as follows.

[THE QUESTIONS ARE REPEATED IN THE ANSWERS FROM THE TREASURY THAT FOLLOW:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 12, 1993

The Honorable Bill K. Brewster
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Brewster:

This is in response to your questions concerning the Administration's modified Btu energy tax proposal presented in connection with my testimony before the Ways & Means Committee.

We have been working on this proposal for the last several weeks and have just recently finished the legislative language. Your questions were helpful to us in developing the proposal. I have enclosed our responses to your questions. Please let us know if we can be of further assistance in this matter.

Sincerely,

Lloyd Bentsen

Enclosure

Answers to Written Questions Submitted to Secretary Bentsen in Connection with the Secretary's Appearance before the Ways and Means Committee, March 10, 1993

NOTE: Answers to all questions reflect the Administration's proposal as drafted in the legislation introduced to Congress by the Administration on May 3, 1993. As you are aware, discussions are continuing regarding certain aspects of the proposal and are expected to continue during the House Ways and Means Committee markup.

Question 1:

Is the Administration's current thinking that the appropriate collection points for the Btu tax to impose the tax closer to the source of the energy or closer to the consumption of the energy?

Answer:

The tax on each fuel is collected at a point that satisfies three criteria. (1) The point of collection minimizes the number of taxpayers (or tax collectors). This reduces administrative burdens on both the IRS and taxpayers. (2) The point is sufficiently far downstream to ensure that imported products and domestic products are taxed at the same rate. (3) The point is sufficiently far downstream to ensure that fixed-price contracts do not prevent passthrough of the tax to the end user.

Question 2:

Specifically, where does the Administration intend to impose the collection point where an electric utility is involved, and does your answer vary depending on the fuel involved: coal, gas, nuclear, or hydropower?

Answer:

For electricity generated from fossil fuels, the tax is imposed on the fossil fuel and not on the electricity generated from the fossil fuel. Nuclear-generated electricity and hydroelectricity are taxed directly, with the tax imposed on, and remitted to the Government by, the utility (or other producer).

Question 3:

Where does the Administration intend to impose the collection point on natural gas and does your answer vary depending on whether the gas is sold by a pipeline or utility in its traditional merchant role or if the gas is merely transported by a pipeline or a utility for others, such as a broker and a large industrial user?

Answer:

The tax on natural gas will be imposed at the city gate (or equivalent in the case of end users that receive gas directly from the pipeline); the local distribution company (or end user receiving the gas from the pipeline) will be liable for the tax, but the tax will be collected and remitted to the Government by the pipeline

Question 4:

In light of State regulatory commissions' concerns that federal legislation not encroach on the States' authority to determine the rate treatment of utility costs, how does the Administration intend to ensure that electric and gas utilities will be able to pass through the Btu tax to the ultimate consumer?

Answer:

Utilities will not be allowed to use accelerated cost recovery for periods during which the energy tax is not completely passed through to end users.

Question 5:

The Administration's proposal indicates there will be an exemption for feedstock and other non fuel uses of energy. Will this exemption apply to fuel used to operate a facility to produce fuel? Examples include: a gas processing plant that burns gas in the process of producing liquefied natural gas; gas that is used to produce steam that is injected into a reservoir for enhanced oil recovery; or gas that is produced and then injected in a reservoir for secondary or tertiary oil production.

Answer:

Nonfuel uses of fossil fuels, including feedstocks, are exempt, but in general, the energy tax applies to all fuel uses of energy. There are four circumstances, however, in which energy used to produce <u>fossil fuel</u> energy will not be taxed; exemptions are provided for (1) crude oil or natural gas used, on the premises where it is produced, to produce crude oil or natural gas, (2) crude oil and petroleum products (other than natural gas) used in a refinery or natural gas used in a natural gas processing or fractionation plant, (3) natural gas and coal used in enhanced oil recovery for heavy oil, and (4) coal and petroleum products used in the production of synthetic natural gas.

Question 6:

Has the Administration considered a floor price for oil as an alternative to the Btu tax?

Answer:

The Administration considered a number of alternatives to its proposed modified Btu tax, and determined that the proposed tax had the right combination of revenue generation, environmental and energy security benefits, regional neutrality, and balanced impact on market shares of our various energy sources. The Administration rejected taxes aimed at a specific fuel, such as gasoline or oil imports, because they would have a disproportionate impact on some regions of the country.

Question 7:

Finally, to avoid the regional disparities caused by taxing different energy sources at different rates, would the Administration consider converting the Btu tax into a federal excise tax?

Answer:

The Administration's proposed modified Btu tax is, in fact, a federal excise tax.

Mr. BREWSTER. In general, I think your plan is very well thought out, and I commend you on coming up with a very good plan. I do have some specifics that I would hope we could adjust a little as we go through.

Like Mr. Jefferson, I have some real concerns in reducing the deductibility of the business lunch and entertainment from 80 to 50 in that most of us don't have a New Orleans in our district. And it certainly affects employment in States like Oklahoma where tourism is the number two industry in our State. It is extremely important to us.

But, today, my questions will mainly center around energy issues. I think all of us are aware there is going to be an energy tax. It must be both fair and collectible. I think the collectibility parts are the things that are concerning a lot of people right now, and a lot of people have questions on that.

Did I understand you to say that the administration is leaning toward actually taxing gasoline as it exits the refinery? Is that the plan?

Secretary BENTSEN. Exits the refinery rather than the input to the refinery.

Mr. BREWSTER. That is very important to those of us who have refineries, in keeping us in a fairness position with foreign, imported product.

Secretary BENTSEN. I couldn't agree more.

Mr. BREWSTER. The second point, what about natural gas? Is the move toward burner point, burner tip as far as the collection point on natural gas at this time?

Secretary BENTSEN. We have not resolved as to the point, but we are talking about, at this point, at the outlet of the pipeline rather than at the input of the pipeline. Now, the exact place at that point we are trying to decide, insofar as the efficiency and the collection of the tax.

Mr. BREWSTER. I would encourage you to consider the burner tip in that it makes LDCs and the direct seller the collection points, and it is more collectible that way, in my opinion.

What about electricity? Where will be the collection point as far as Btu tax on electricity?

Secretary BENTSEN. It is the fuel source to the utility for the generation of electricity, as it is sold to the utility.

Mr. BREWSTER. Okay, so it would be as it is sold to the utility, regardless of fuel?

Secretary BENTSEN. No, I can't say that, Mr. Brewster, regardless of all fuels. Some of those things haven't been settled yet.

Mr. BREWSTER. I would think that it is certainly better for the utility standpoint, when they go before the rate-making bodies in their particular States, if it is on fuel. But according to fuel source it could certainly be a problem in that regard. But collectibility has to be one thing that I think is extremely important.

The administration, I think, has thought of a lot of the issues, and I would hope that we could work with them, especially on the energy ones as time goes on, and hope to be able to support the entire package.

Secretary BENTSEN. Congressman, thank you for that. We are trying to get all the input we can from industry as far as its application to determine what is most feasible and effective.

Mr. BREWSTER. Okay. Thank you.

Secretary BENTSEN. Surely.

Chairman ROSTENKOWSKI. Mr. McDermott, Mr. Stark, Mr. Santorum.

Mr. SANTORUM. Thank you, Mr. Chairman.

It is good to have you here, Mr. Secretary. While we have not had a chance to meet, I will say that I am an admirer of yours, and I don't envy your position in having to necessarily defend this package, which I have some severe problems with. I trust, knowing your history here in this institution, that this necessarily wouldn't be all you would want to do, either.

Let me first talk to you about some of the charts that you had in your presentation and take issue with a couple of them.

Number one is the chart you had on what the energy tax will cost the American family. You have this economic class set up, and you use the numbers here of family income.

I think this whole concept of family income being thrown in is a smoke and mirror and a bit of a distortion tactic.

I would like to see how the Clinton proposals are going to affect people, where the real bottom line is, where most people see themselves as far as real income, whether that is adjusted gross income or taxable income. I don't care what numbers you use, but to use family income as a way to justify this, that this is not going to hit working-class and lower-income Americans, I think is smoke and mirrors, and I don't think is particularly genuine.

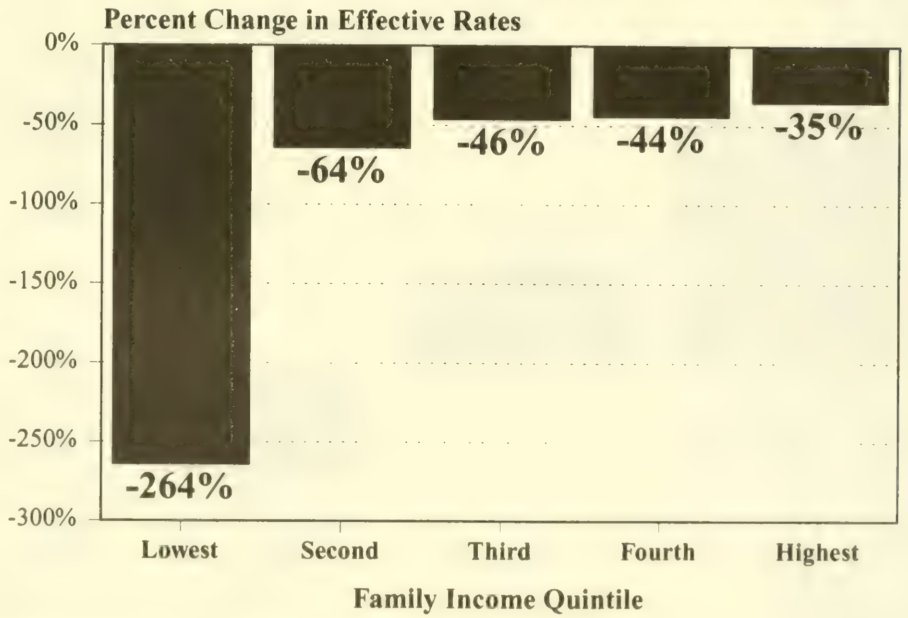
The other chart I would like to talk about is, again, the continuing attempt by this administration and Members on the other side in the Congress to rewrite the 1980s and what actually happened and what is going on in the economy. This is revisionist history. I find it very troubling.

You use the term—affluent have not been paying their fair share. And you throw in taxes, and you talk about income and effective rates. Well, in this number is the Social Security tax increases, as you know. That is not what the Reagan, quote, Reagan revolution was all about and not what we were all about in the early 1980s. We were talking about income tax rates—not Social Security and payroll taxes. We were looking at income taxes as being a stimulus.

If you look at this chart—the rates paid by family income according to quintile—you will see that the lowest have had the greatest percentage reduction in their income taxes and the highest-income bracket have had the lowest percentage reduction.

[The chart referred to follows:]

Falling Income Tax Rates by Income Quintile, 1980 vs. 1992

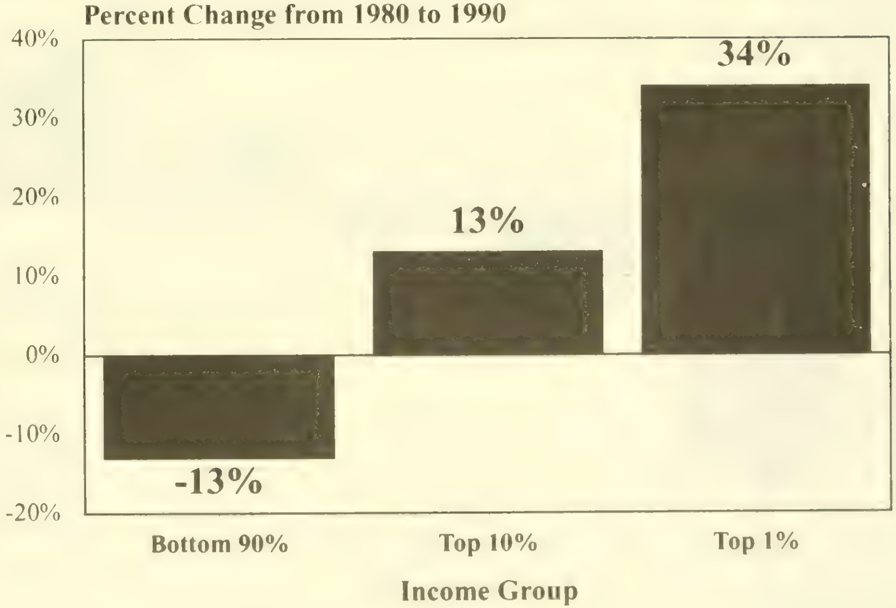


Source: Congressional Budget Office.

Mr. SANTORUM. If you look at the next chart, who paid the additional taxes, you will find the bottom 90 percent in income paid less taxes in 1990 than they did in 1980, less taxes in 1990 than 1980. The top 10 percent paid 13 percent more taxes. And the top 1 percent paid 34 percent more taxes in 1990 than they did in 1980.

[The chart follows:]

Who Paid Additional Taxes, 1980 Compared to 1990

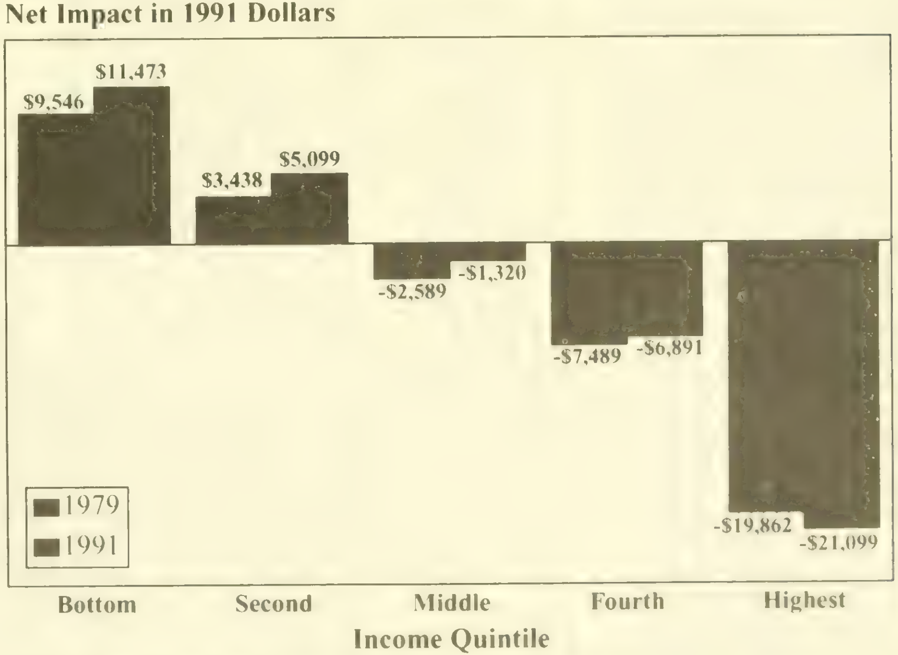


Source: Internal Revenue Service.

Mr. SANTORUM. Finally—and this is probably the most important of all the charts, because what this does is show the cumulative effect of all government programs, of all spending, of all taxes. You will see that with the lowest income level, the bottom 20 percent actually got more net from the government in 1991—11,473 to 9,546.

[The chart follows:]

Changing Impact of Federal Taxes and Spending on Families with Differing Incomes



Source: U.S. Bureau of the Census

Mr. SANTORUM. I would like you to comment on how you can come here and try to make these arguments that we need to revise our tax system, we need to penalize and tax higher-income peoples. Because this wasn't what was going on in the 1980s. I can accept your argument if you want to make a policy argument. We want people who are wealthier to pay more. Fine. But I don't think that should be based on a false premise which is that they haven't been paying more over the 1980s. You have about 15 seconds to respond.

Secretary BENTSEN. If you want to talk about smoke and mirrors, I think you have shown me some. If you want to go back and talk about family income as an index, I don't think that Jerry Ford was talking about smoke and mirrors when he used it. So it goes back quite a while, family income and trying to show the true income of a family. It is not a tax base. We are not talking about that.

Mr. SANTORUM. I accept that.

Secretary BENTSEN. I will be through in just a minute. We are talking about the total income.

If you have a family that has a situation—if you have a man working for a company and the employer does not pay the insurance premium for him for his health insurance, that is one set of income. If you have another fellow working for a company and the company does pay his health insurance premium, that becomes a part of his income, even though it is not a part of his taxable base. And that is the way the family income index works, and I think it is a fair one. We see the Joint Tax Committee using an expanded base and trying to show what true family income is.

I was amused by the fact that you are talking about lower-income people paying less taxes. They are making less money, too. And you are talking about the people paying more taxes. That is right. The top one and two-tenths percent are paying more taxes, and they are making almost 50 percent more income in the last ten years than they did before. So that is the way those numbers come out, and I stand by the numbers I have presented to the committee.

Mr. RANGEL [presiding]. The time of the gentleman has expired.

Mr. Crane is recognized.

Mr. CRANE. Thank you, Mr. Chairman.

Mr. Secretary, I want to welcome you in your new position. We are looking forward to working with you.

I have a few quick questions on this Btu tax and also your graph. What is the percentage increase on natural gas in terms of the Btu tax?

Secretary BENTSEN. The percentage increase—let me have that for Btu. We will get it for you in just a second.

Mr. CRANE. I am also going to ask about oil and coal. Is nuclear in there, too?

Secretary BENTSEN. I will give you the whole list.

Nuclear tax is, I understand, at the average rate for fossil fuels.

Mr. CRANE. What is the fossil fuel percentage increase?

Secretary BENTSEN. All right. For 1996, on gasoline it is 5.7 percent, 6.4 percent for heating oil, 4.1 percent for natural gas, 3.3 percent on your electric bill monthly.

Mr. CRANE. You don't have the figures for coal or nuclear or hydroelectric broken down?

Secretary BENTSEN. Coal is the electricity price because it goes to utilities.

Mr. CRANE. Exclusively?

Secretary BENTSEN. No, no, but that is the major utilization, major use for it, Congressman.

Mr. CRANE. Solar and wind are not taxed?

Secretary BENTSEN. That is correct.

Mr. CRANE. All right. The reason I asked that is to get some idea about how the allocation of the tax increases was made based upon one of the points that Mr. Kopetski brought up here, and that is hydroelectric and nuclear far and away are the two cleanest energy sources on the face of the earth. And I understand your geographic argument. I suppose, though, that we could build reservoirs in the Mississippi and take care of Illinois, but we are the most nuclear State in the Union, too.

On the question of this graph here about the energy tax and the cost to the average family, how can you conclude that the family making $20,000 a year will pay no energy tax?

Secretary BENTSEN. Because of what we have done with the earned income tax credit, what we have done with food stamps, what we have done with LIHEAP. Those things more than make up for the tax.

Mr. CRANE. Well, you know, every time we have passed a sales tax, historically, we have exempted food and medical prescriptions. However, there are a lot of Btus that go into the production of food, and there is no exemption here for the working poor when it comes to food purchases. That includes the farm implements, farm machinery, the food processing, transportation, packaging, and the higher labor costs that will inevitably attend this. Your fuel costs and all that has to be passed through to that person in the lowest income bracket when he buys food at the local store.

Secretary BENTSEN. Absolutely, we understand that, and that is why we took that into effect as we calculated what had to be spent on earned income tax credit, on food stamps, and on LIHEAP.

Mr. CRANE. So this graph, then, incorporates things other than the energy tax? You are not talking about the energy tax here? I mean, they are paying the energy tax, but they are being given compensation in other ways to try to neuter that.

Secretary BENTSEN. That is correct.

Mr. CRANE. How is it that the family making $200,000 jumps from $76 to $1,198 in monthly taxes? If I make $200,000 in one, I am paying $1,198. If I am making $199,999——

Secretary BENTSEN. Now you are looking at the whole package. You are looking at the income tax rate increase in addition.

Mr. CRANE. Okay. So this is not really germane to energy taxes, this graph? It is misleading?

Secretary BENTSEN. Well, it is germane to those people who are under the increase in the income tax rate.

Mr. CRANE. Well, except my point is they are not—these figures here for energy taxes—not relevant.

Secretary BENTSEN. I am not sure which chart you are looking at.

Mr. CRANE. It is your one from the Department of Treasury. It is number four in your handout. But, I mean, these figures are not really related to the energy tax that they pay.

Secretary BENTSEN. No, it is related to the——

Mr. CRANE. This is adjusted after the other calculations, the tax increases and tax relief?

Secretary BENTSEN. That is correct.

Mr. CRANE. Well, I was confused about that because everybody will feel the impact of an energy tax. I mean, you tax Btus, and it is felt in every aspect.

Secretary BENTSEN. All of them will pay it, and we will more than make up for that for those people under $30,000 a year.

Mr. CRANE. We are sure we can offset that because people in lower-income brackets tend to have larger families than people in the higher brackets.

Secretary BENTSEN. Congressman, we share that concern, and that is what we tried to address.

Mr. CRANE. Very good. I would like to make a unanimous consent request, Mr. Chairman, for submission of questions in writing to you later because we ran out of time.

Secretary BENTSEN. Congressman, we would be pleased to have them.

Mr. CRANE. Thank you so much.

[The information follows:]

REPRESENTATIVE PHILIP M. CRANE
Additional Questions for Secretary Bentsen

(1) The Administration's stimulus/investment program includes a liberalization of the rules for computing depreciation under the corporate AMT. As stated in Treasury's supporting material, the purpose is to reduce a tax impediment to capital investment by corporate businesses.

I am also concerned about the impact of the corporate AMT on investments by state and local governments in infrastructure improvements. As you know, the Tax Reform Act of 1986 had the effect of subjecting a portion of state and local bond interest to the AMT -- interest that had historically been fully tax-exempt. Under the adjusted current earnings (ACE) provision, 75% of state and local bond interest is now effectively taxed under the AMT. This acts as a disincentive for corporations, such as property and casualty insurance companies, to provide capital needed by states and municipalities. In considering AMT changes to encourage investment, would you support a similar liberalization of the AMT rules relative to state and local bond interest?

(2) Deployment of technology, such as the building of an information "superhighway," takes many years. Has the Administration considered any long-term capital recovery incentives for businesses which are deploying new technology?

(3) Large capital intensive corporations, which are only eligible for a temporary incremental investment tax credit, will pay out substantially more cash because of the 2% corporate income tax rate increase than the benefit flowing from the investment tax credit. This net cash outflow will eventually reduce internally generated funds for future capital programs. How does this situation help the economy in the long run?

(4) For some time I have had an interest in the accumulated earnings tax (AET). I believe the AET is an unnecessary intrusion into the corporate decision making process. In my view the AET particularly does not make sense as it applies to widely held corporations, and this view holds despite the modest changes you are proposing in the area of capital gains. I would appreciate your position on repeal of the AET as it applies to widely held corporations. In the event that you do not view AET repeal favorably, I would also be interested in your view on creating a safe harbor so that corporations at least know when the IRS may choose to impose this tax upon them. (See attached background.)

REPEAL THE ACCUMULATED EARNINGS TAX

HON. PHILIP M. CRANE

OF ILLINOIS

IN THE HOUSE OF REPRESENTATIVES

Thursday, January 3, 1991

Mr. CRANE. Mr. Speaker, today I am introducing legislation which would repeal the accumulated earnings tax [AET] as it applies to widely held corporations.

The accumulated earnings tax, section 532 of the Internal Revenue Code, has been imposed on closely held corporations that accumulate earnings and profits (rather than pay them out as dividends) in order to assist their shareholders in avoiding income taxes. The 1984 Deficit Reduction Act made the accumulated earnings tax applicable, for the first time, to widely held corporations. The AET was an understandable congressional response to the formation of investment corporations which were created for no true business purpose but were simply devised to take advantage of what was at the time a huge disparity between the capital gains tax rate and the dividend tax rate, a difference which no longer exists. However, although this concern seemed legitimate for closely held corporations, it is hard to understand why there would be this same concern with respect to manipulating dividend policy in a widely held corporation.

Were section 532(c) simply unnecessary, I suppose we could just let it stay on the books. However, the continued existence of section 532(c) is actually quite harmful to the decision making process of legitimate companies. Continued application of section 532(c) to widely held corporations means that the IRS will be essentially interfering in the corporation's decision of whether or not to pay a dividend. If the board of directors of a corporation believes the corporation should accumulate funds to expand, invest, or conduct research and development, it must do so with some trepidation knowing the IRS may invoke the accumulated earnings tax. Because of the continued threat of the applicability of the accumulated earnings tax to widely held corporations, there may be a tendency for corporations to pay dividends, even when corporate resources should be accumulated for other purposes.

Whether the IRS is applying the AET with the intention of collecting it or whether the imposition of the AET is used as a bargaining chip to resolve other issues, the effect is the same—unnecessary and harmful interference in decisions that are best left to the corporation. We need to free corporate directors from the prospect of the AET and encourage companies to make capital investments in order to grow and compete in the future. This Congress, at the very least, should not be discouraging corporations from retaining capital for investment purposes.

This legislation has received hearings by the Ways and Means Subcommittee on Select Revenue Measures, and it is my hope to offer this legislation as an amendment to appropriate legislation in the Ways and Means Committee in the 102d Congress. I believe this legislation makes sense and hope my colleagues can lend their support.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ECRETARY OF THE TREASURY

May 12, 1993

The Honorable Philip Crane
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Crane:

This is in response to your questions concerning business taxation presented in connection with my testimony before the Ways & Means Committee.

We have been working on the Administration's proposal for the last several weeks and have just recently finished the legislative language. I have enclosed our responses to your questions. Please let us know if we can be of further assistance in this matter.

Sincerely,

Lloyd Bentsen

Lloyd Bentsen

Enclosure

Answers to Written Questions Submitted to Secretary Bentsen in Connection with the Secretary's Appearance before the Ways and Means Committee, March 10, 1993

NOTE: Answers to all questions reflect the Administration's proposal as drafted in the legislation introduced to Congress by the Administration on May 3, 1993. As you are aware, discussions are continuing regarding certain aspects of the proposal and are expected to continue during the House Ways and Means Committee markup.

Question 1:

The Administration's stimulus/investment program includes a liberalization of the rules for computing depreciation under the corporate AMT. As stated in Treasury's supporting material, the purpose is to reduce a tax impediment to capital investment by corporate businesses.

I am also concerned about the impact of the corporate AMT on investment by state and local governments in infrastructure improvements. As you know, the Tax Reform Act of 1986 had the effect of subjecting a portion of state and local bond interest to the AMT -- interest that had historically been fully tax-exempt. Under the adjusted current earnings (ACE) provision, 75% of state and local bond interest is now effectively taxed under the AMT. This acts as a disincentive for corporations, such as property and casualty insurance companies, to provide capital needed by states and municipalities. In considering AMT changes to encourage investment, would you support a similar liberalization of the AMT rules relative to state and local bond interest?

Answer:

The Tax Reform Act of 1986 requires that tax-exempt municipal bond interest be included in the base of the alternative minimum tax under the adjustment for adjusted current earnings (ACE). The purpose of including tax preferences in the alternative minimum tax base is to ensure that in each taxable year the taxpayer pay a significant tax on an amount more nearly approximating economic income. However, for capital-intensive firms the depreciation component of the ACE adjustment can substantially reduce the firm's incentive to invest.

The Administration's proposal would provide AMT relief by repealing the ACE adjustment for depreciation, but would retain the depreciation preference in the AMT base. The elimination of the ACE depreciation adjustment would cause many AMT taxpayers to become regular taxpayers. Although the Administration's proposal does not directly address the treatment of tax-exempt interest under ACE, it would also reduce the significance of the ACE adjustment for taxpayers remaining subject to the AMT. In either

case, the proposed AMT change would indirectly benefit many AMT taxpayers that also have tax-exempt municipal bond income. In addition, the Administration is examining cost-effective ways to assist states and municipalities raise the capital needed for infrastructure development and maintenance.

Question 2:

Has the Administration considered any long-term capital recovery incentives for businesses which are deploying new technology?

Answer:

The administration's proposal offers three direct long-term incentives for firms deploying new technology. First, the proposal would permanently extend the research and experimentation credit. Second, the proposál would encourage the development of high-speed rail by exempting private activity bonds used to finance such projects from the State private activity bond volume limitations. And third, "high-tech" businesses would be eligible for the investment tax credit, as well as for capital gains tax relief. In addition, by seeking to significantly reduce the deficit, the proposal offers the prospect of lower long term interest rates which also benefits businesses engaged in long-term ventures.

Question 3:

Large capital intensive corporations (eventually) will pay out substantially more in taxes because of the 2% corporate income tax rate increase than the amount of tax benefit they receive from the temporary incremental investment tax credit (IITC). This net cash outflow eventually will reduce internally generated funds for future capital programs. How does this situation help the economy in the long-run?

Answer:

Focusing on just one element of the Administration's economic plan can paint a misleading picture. Taken as a whole, the Administration's economic proposal will benefit the economy, including the corporate sector, in the long run. One important benefit comes from deficit reduction, due party to revenues attributable to the increase in the top corporate income tax rate. Interest rates have already declined in recognition of the serious intent of this Administration to reduce the budget deficit. Thus, even if the increase in the top rate does reduce the internally generated funds for the 3,000 or so most profitable corporations, these corporations should be more easily able to finance their investment by issuing stock or debt.

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Question 4:

I would appreciate your position on repeal of the accumulated earnings tax (AET) as it applies to widely held corporations. In the event you do not view AET repeal favorably, I would also be interested in your view on creating a safe harbor so that corporations at least know when the IRS may choose to impose this tax upon them.

Answer:

Because of the increase in the top individual income tax rates, the Administration believes it is appropriate to revise the accumulated earnings tax. As you know, the accumulated earnings tax has been around since the early days of the income tax to prevent abusive transactions in which owners of a business retain excess funds inside a corporation, rather than pay out dividends or salaries upon which they would be taxed. In order to retain its role in preventing such potentially abusive taxpayer behavior, the Administration proposes increasing the rate of the AET to the proposed to individual tax rate of 39.6 percent. The current "safe harbor" rules will, however, continue to be available. Thus, the minimum exemption of $250,000 ($150,000 for certain service corporations) will continue to apply, as will the established rules used to calculate working capital for inventory purposes. Firms will also continue to be permitted to accumulate funds as part of a business plan for future expansion. It is possible that more clarity regarding safe harbors could reduce uncertainty about the application of the accumulated earnings tax. I would welcome any suggestions that you might have regarding appropriate clarification of the current rules.

Mr. RANGEL. Without objection, the Chair asks unanimous consent to have questions for Senator Bentsen from Representative Don Sundquist to be entered into the record.

[The information follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 12, 1993

The Honorable Don Sundquist
U.S. House of Representatives
Washington, D.C. 20515-4207

Dear Mr. Sundquist:

This is in response to your questions concerning the Administration's modified Btu energy tax proposal presented in connection with my testimony before the Ways & Means Committee.

We have been working on this proposal for the last several weeks and have just recently finished the legislative language. Your questions were helpful to us in developing the proposal. I have enclosed our responses to your questions. Please let us know if we can be of further assistance in this matter.

Sincerely,

Lloyd Bentsen

Enclosure

Answers to Written Questions Submitted to Secretary Bentsen in Connection with the Secretary's Appearance before the Ways and Means Committee, March 10, 1993

NOTE: Answers to all questions reflect the Administration's proposal as drafted in the legislation introduced to Congress by the Administration on May 3, 1993. As you are aware, discussions are continuing regarding certain aspects of the proposal and are expected to continue during the House Ways and Means Committee markup.

Question 1:

The Btu tax as proposed would be levied on crude oil refined by domestic refineries. Those refineries would then attempt to recover that tax by passing it along in the price of refined products (gasoline, diesel, etc.) sold. It is my understanding that under the GATT, taxes on imports can only be levied if there is a tax on like products. Since the proposed tax is not being levied directly on domestically produced refined products, can imported refined products be taxed without violating GATT?

Answer:

The tax will be imposed on refined petroleum products rather than on crude oil. The same tax rates will apply to each class of refined petroleum products, regardless of their origin. This treatment is fully consistent with the GATT.

Question 2:

The proposed Btu tax will be levied on domestically produced coal at the minemouth at an average rate of about $5.50 per ton. Under the proposal, can the Btu tax be imposed on imported coal? If not, the resulting impact of the tax will be to put domestically produced coal at a competitive disadvantage.

Answer:

The tax on coal, whether domestically produced or imported, will be based on the actual Btu content of the coal and will be imposed at the point of receipt by the end user. The end user will be liable for the tax and remit the tax directly to the Government.

Mr. RANGEL. One question. Mr. Secretary, there are no provisions to offset the energy tax for the unemployed or those on welfare, are there?

Secretary BENTSEN. Well, you have got LIHEAP and food stamps.

Mr. RANGEL. Okay.

On behalf of the Chairman, we really want to thank you for your testimony this morning and look forward to working with you as well as we have in the past. Thank you so much. The committee stands adjourned until 2 p.m.

Secretary BENTSEN. Thank you.

[Secretary Bentsen's answers to questions submitted by Mr. Bunning follow:]

QUESTIONS FOR SECRETARY BENTSEN FROM CONGRESSMAN JIM BUNNING

I have some concerns about the intangibles title contained in HR 13. Specifically I believe we should exclude purchased mortgage servicing rights (PMSR) from the 14 year amortization rule. As you know, it is a well established industry practice for PMSR to be amortized over a 7–10 year period. Last year, as chairman of the Senate Finance Committee, you worked with Assistant Secretary Goldberg closely to eliminate this provision from HR 11. The proposed change would increase the cost of homeownership and further, overturn practices sanctioned by the IRS and the tax courts since the early 1970s.

It is generally held that PMSR is different from other intangibles. It is quantifiable, severable and marketable. Because PMSR has these characteristics, the Federal Reserve, OCC, OTS, and the FDIC have all deemed PMSR to be the only intangible that is eligible for tier I capital calculations. As the nation's chief financial officer with responsibility for the regulations of financial institutions, would you please tell me what effect this change would have on bank and thrift capital? What effect would this provisions have on taxpayers in relation to the RTC, and future FDIC or RTC acquisitions?

Answer. Extending the amortization period of PMSR will not alter the overall amortizable amount, but will decrease the amount of PMSR that can be deducted from taxable income in a given year. Consequently, banks and thrifts may incur additional tax expense. Any additional tax expense may or may not affect bank capital depending on the ability of the bank to book a deferred tax asset as allowed under Financial Accounting Standard 109 and proposed federal banking agency rules.

Very few depository institutions hold significant amounts of PMSR. As of year-end 1992, only 25 banks and 44 savings associations had PMSR in excess of one percent of their assets. Changing the amortization period of PMSR will have almost no effect on the levels of bank or savings association failures and FDIC or RTC acquisitions, or on taxpayer costs associated with such failures and acquisitions.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 2 p.m.]

Chairman ROSTENKOWSKI. The committee will come to order.

Good afternoon. The committee will now resume its examination of proposals included in President Clinton's budget. Having heard from the administration's economic team, we will now turn to the programmatic issues within the Department of Health and Human Services.

I would like to extend a warm welcome to Secretary Donna Shalala on her first visit to the Committee on Ways and Means. I am confident, Madam Secretary, that your leadership and the management skills will be an important asset in your Department.

Dr. Shalala, you and I share a common challenge. That is, a substantial portion of President Clinton's agenda runs through your Department and will have to be enacted by this committee. Between the current proposals to reduce this country's deficit and future work on health care reform, I expect that you will become a

familiar face, and I look forward to working with you in partnership on the issues that are common to both this committee and to your Department.

I have told you this on a personal basis. I like your style. I like your aggressiveness. I think that you will bring to both the Department and to this committee an atmosphere of getting things done. And I appreciate your taking time to come and visit with us and give us your views.

Any comments?

Madam Secretary, you may begin.

STATEMENT OF HON. DONNA E. SHALALA, SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary SHALALA. Thank you very much, Mr. Chairman, and thank you for your very warm words of welcome. I, too, look forward to working with you and with the other members of the committee.

I am honored to appear before you today to discuss the proposals in President Clinton's economic package that fall within this committee's jurisdiction. Although most of the decisions affecting the programs within the committee's jurisdiction have been made, details regarding a number of the proposals are still being developed, and I will keep the committee informed of all the final decisions.

The President has undertaken an ambitious agenda to strengthen the economy, to create jobs, and to promote economic security for American families. To protect our future, he has presented to Congress and the American people a bold plan that will stimulate economic growth both by investing wisely in the American people and by cutting the Federal deficit. We must take this historic opportunity to do both, and we must act quickly.

Critical changes in the major programs under the committee's jurisdiction are central to this investment and deficit reduction process. The success of major portions of the President's plan rest in your hands. We will rely on your considerable expertise, experience, and involvement; and we are eager to work with you.

First, health care reform and Medicare. One of the most significant investments in America's future will be to reform our health care system. As a member of the Task Force on Health Care Reform chaired by Mrs. Clinton, I would like to express my appreciation to this committee for its diligence in working towards consensus on health care reform last year. I know that we will all benefit from that experience as we continue to work for fundamental systemic change.

You know as well as I that neither deficit reduction nor serious investment in America's future can be accomplished in the absence of health care reform. One-half of the projected increase in the Federal deficit over fiscal years 1994 through 1998 is due to growth in Medicare and Medicaid spending. Health care spending will rise from 14 percent to 19 percent of the gross domestic product—GDP—by the end of this decade, crowding out other resources and opportunities for our economic security.

The President has promised that the health care reform plan he presents to you in May will control health care costs and guarantee families the security of health coverage. In doing so, the plan will

build a stronger, more rational health care service delivery system that relies on prevention and primary care, that protects quality, that minimizes bureaucratic inefficiency, and responds to the needs of real people.

The daunting task of cost containment must include short-term measures and more comprehensive reforms to stabilize public and private health care spending in the long run.

This task begins in the President's deficit reduction plan. A down payment on our overall cost control effort, in the form of our proposed Medicare savings, is intended to reduce the deficit without major structural reforms. Structural reforms are considered more appropriate within the context of overall health care reform.

The Medicare deficit reduction proposals are not cuts. Rather, they will curb the rate of Medicare spending growth from 13 to 11 percent annually. And most of the savings are from health care service providers, not beneficiaries.

A more detailed written description of the Medicare proposals, as well as those for human services and Social Security, are attached to my statement which, with your permission, I would like to provide for the hearing record.

Chairman ROSTENKOWSKI. Without objection.

Secretary SHALALA. In Medicare part A, the President has proposed an extension of the current policy of increasing hospital payments at a rate of market basket minus 1 percent and moving the annual increase from October to January, similar to the update for other Medicare services.

Other changes under Medicare part A include:

Gradually lowering Medicare indirect medical education payments to teaching hospitals;

Extending the current provision in statute whereby inpatient hospital capital payments are reduced by 10 percent;

Revising Medicare direct medical education subsidies to favor training for primary care and basing payments on a national per-resident amount, rather than a hospital-specific amount;

Eliminating hospital-based home health agencies' upward adjustment to their per-visit cost limits; and

Eliminating Medicare return on equity payments to proprietary skilled nursing facilities.

In Medicare part B, as you know, the current law provision setting monthly premium amounts expires in 1995. The President has proposed to extend the levels between program costs and the premium at an appropriate level for 1996 and thereafter. Another proposal will extend the current requirement that hospital outpatient capital payments be reduced by 10 percent.

Other Medicare part B proposals include:

Reducing payments for clinical laboratory services and extending the current law 2 percent ceiling on updates through 1998;

Lowering physician fee schedule updates by 2 percentage points for all nonprimary care services;

Phasing in a resource-based system for practice expenses under the physician fee schedule;

Changing the default formulas under the Medicare volume performance standard program to provide for a spending growth rate that is closer to that for gross domestic product;

Bundling payments for inpatient radiology, anesthesia and pathology services into a fixed payment per discharge via hospital diagnostic related groups;

Encouraging the submission of part B claims via electronic format by charging physicians and suppliers $1 per paper claim;

Establishing a single fee for surgery regardless of whether the primary surgeon uses an assistant at surgery;

Extending physician ownership and referral prohibitions to additional services;

Reducing payments for durable medical equipment by tightening the national limits and reclassifying certain items, giving Medicare contractors more authority and flexibility in certain areas; and

Setting the EPO at non-U.S. market rates from $11 per thousand units to $10 per thousand units.

In addition to these savings, we will continue our efforts to identify cases where Medicare made a mistaken primary payment, Parts A and B, for services when a beneficiary had other primary insurance, either public or private, and we propose to extend the secondary payment rules for certain disabled beneficiaries and for beneficiaries with end stage renal disease.

In welfare and family support programs, any realistic attempt to change the face of welfare must address both the lack of parental support which millions of impoverished children face every day and the means to help people get on their feet through job training, education, and, ultimately, productive employment. The President and I have pledged to strengthen child support enforcement, to improve family support services, and to end welfare as we know it.

I want to take this opportunity to reiterate that this administration is committed to reforming our welfare system. However, we must undertake health care reform first. A new health care system is a precondition to moving all families to self-sufficiency. Our goal is to change the welfare system to empower Americans to improve their lives and the lives of their children.

In the near future, the President will announce a group on welfare reform to develop strategies to meet the following four goals:

First, to ensure that full-time workers with families do not have to raise their children in poverty;

Second, holding absent parents financially responsible for their children;

Third, providing people who can work with the training and support they need to move off welfare;

And, finally, to make cash welfare a transitional program.

We believe that real welfare reform involves changes in a range of Federal policies and programs, and President Clinton's economic plan addresses some of those changes by including proposals designed to make work pay. For example, the plan proposes to expand the Earned Income Tax Credit to ensure that a family of four will not be forced to live below the poverty level if one of the parents works full-time at a minimum wage job.

The President's plan includes both investments and deficit reduction measures in specific programs of the Administration for Children and Families—ACF. Two investments will be directed toward further strengthening American families. The first is for parenting and family support services, and the second investment contains

moneys for the child care and development block grant. This investment will provide additional resources to help low-income families who need child care services.

The first ACF deficit reduction measure involves eliminating the enhanced Federal funding matching rates offered to States for many years as incentives to carrying out special aid to families with dependent children—AFDC—administrative activities. We propose to bring these incentive match rates back to 50 percent, which is the normal match rate for State administration of the AFDC program. Similar policies also will apply to the Medicaid and food stamp programs.

Secondly, the President has enunciated some immediate actions which can be taken to strengthen the enforcement of child support and to add to the overall goal of deficit reduction. Specifically, President Clinton has identified Federal savings that will be achieved through several program enhancements. These efforts would also serve to support and complement long-range reforms to child support enforcement that will be put forth by the welfare reform task force.

The twin goals of investment and deficit reduction will be pursued in the largest Federal program of all, Social Security. President Clinton proposes stimulus monies and long-term investments in the efficiency and services of the Social Security Administration—SSA. The President's fiscal year 1993 supplemental budget request includes monies to process the backlog of disability claims, SSA's most crucial problem, and to improve automation and infrastructure.

Multi-year investments will be used to continue the critical modernization of SSA. This investment will permit a long-needed computer system redesign and lay the groundwork for the automation systems that will be necessary to handle the increased number of claims expected when the baby boom generation retires.

President Clinton proposes that the Social Security Administration's contribution to deficit reduction will come in two ways. First, the plan will increase the percentage of taxable Social Security benefits for individuals already taxed. And I want to emphasize this will not increase the number of people paying taxes on their Social Security benefits. Only those with higher incomes, who already pay some taxes on benefits, will have those taxes increased.

Second, the President proposes charging a fee to States for which SSA administers a State supplement of the Federal Supplementary Security Income program. Many States have eligibility requirements that are different from those for the Federal benefit, making determinations complex and costly for SSA to manage. Regardless of the complexity of State rules, the Federal Government incurs costs for all States for which it administers a State supplement, and it is not unreasonable to ask States to assume part of these costs.

Finally, President Clinton's economic package provides a strong foundation for our national prosperity by stimulating the economy, investing in our future, and reducing the deficit. Our impending health care reform package and our future welfare reform actions will build on this foundation.

Mr. Chairman, I look forward to working closely with this committee as we move through the budget reconciliation process, as we strive for health care and welfare reform, and as we develop subsequent initiatives to improve the lives of all Americans.

I will be happy to try to answer any questions you may have.

Chairman ROSTENKOWSKI. Thank you, Madam Secretary.

[The prepared statement and attachment follow:]

STATEMENT OF HON. DONNA E. SHALALA, SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE

I am honored to appear before you today to discuss the proposals in President Clinton's economic package that fall within this Committee's jurisdiction. Although most of the decisions affecting the programs within the Committee's jurisdiction have been made, details regarding a number of proposals are still being developed. I will keep the Committee informed of all final decisions.

The President has undertaken an ambitious agenda to strengthen the economy, create jobs, and promote economic security for American families. To protect our future, he has presented to Congress and the American people a bold plan that will stimulate economic growth both by investing wisely in the American people and by cutting the Federal deficit. We must take this historic opportunity to do both, and we must act quickly.

Critical changes in the major programs under the Committee's jurisdiction are central to this investment and deficit reduction process. The success of major portions of the President's plan rests in your hands. We will rely on your considerable expertise and your involvement. We are eager to work with you.

Health Care Reform and Medicare

One of the most significant investments in America's future will be to reform our health care system. As a member of the Task Force on Health Care Reform, chaired by Mrs. Clinton, I would like to express my appreciation to this Committee for its diligence in working toward consensus on health care reform last year. I know that we will all benefit from that experience as we continue to work for fundamental systemic change.

You know as well as I that neither deficit reduction nor serious investment in America's future can be accomplished in the absence of health care reform. One half of the projected increase in the Federal deficit over Fiscal Years 1994 through 1988 is due to growth in Medicare and Medicaid spending. Health care spending will rise from 14 percent to 19 percent of the gross domestic product (GDP) by the end of this decade, crowding out other resources and opportunities for economic security.

The President has promised that the health care reform plan he presents to you in May will control health care costs and guarantee families the security of health coverage. In so doing, the plan will build a stronger, more rational health care service delivery system that relies on prevention and primary care, protects quality, minimizes bureaucratic inefficiencies, and responds to the needs of real people.

The daunting task of cost containment must include short term measures and more comprehensive reforms to stabilize public and private health care spending in the long run.

This task begins in the President's deficit reduction plan. A <u>down payment</u> on our overall cost control effort, in the form of our proposed Medicare savings, is intended to reduce the deficit without major structural reforms. Structural reforms are

considered more appropriate within the context of overall health care reform.

The Medicare deficit reduction proposals are not "cuts." Rather, they will curb the rate of Medicare spending growth from 13 percent to 11 percent annually. Most of the savings are from health care services providers, not beneficiaries.

A more detailed written description of the Medicare proposals as well as those for human services and Social Security are attached to my statement, which, with your permission, I would like to provide for the hearing record.

In Medicare Part A, the President has proposed an extension of the current policy of increasing hospital payments at a rate of market basket minus 1% and moving this annual increase from October to January similar to the update for other Medicare services. Other changes under Medicare Part A include:

*Gradually lowering Medicare indirect medical education payments to teaching hospitals;

*Extending the current provision in statute whereby inpatient hospital capital payments are reduced by 10 percent;

*Revising Medicare direct medical education subsidies to favor training for primary care and basing payments on a national per-resident amount, rather than a hospital-specific amount;

*Eliminating the hospital-based home health agencies' upward adjustment to their per-visit cost limits; and

*Eliminating Medicare return on equity payments to proprietary skilled nursing facilities.

In Medicare Part B, as you know, the current law provision setting monthly premium amounts expires in 1995. The President has proposed to extend the levels between program costs and the premium at an appropriate level for 1996 and thereafter. Another proposal will extend the current requirement that hospital outpatient capital payments be reduced by 10 percent.

Other Medicare Part B proposals include:

*Reducing payments for clinical laboratory services and extending the current law 2 percent ceiling on updates through 1998;

*Lowering physician fee schedule updates by 2 percentage points for all non-primary care services;

*Phasing in a resource-based system for practice expenses under the physician fee schedule;

*Changing the default formulas under the Medicare volume performance standard (MVPS) program to provide for a spending growth rate that is closer to that for GDP;

*Bundling payments for inpatient radiology, anesthesia and pathology services into a fixed payment per discharge via hospital diagnostic related groups;

*Encouraging the submission of Part B claims via electronic format by charging physicians and suppliers $1 per paper claim;

*Establishing a single fee for surgery regardless of whether the primary surgeon uses an assistant-at-surgery;

*Extending physician ownership and referral prohibitions to additional services;

*Reducing payments for durable medical equipment by tightening the national limits; reclassifying certain items; and giving Medicare's contractors more authority and flexibility in certain areas; and

*Setting epogen (EPO) at non-U.S. market rates from $11 per 1,000 units to $10 per 1,000 units.

In addition to these savings, we will continue our efforts to identify cases where Medicare made a mistaken primary payment (Parts A and B) for services when a beneficiary had other primary insurance, either public or private, and we propose to extend secondary payment rules for certain disabled beneficiaries and for beneficiaries with end stage renal disease.

Welfare and Family Support Programs

Any realistic attempt to change the face of welfare must address both the lack of parental support which millions of impoverished children face every day and the means to help people get on their feet through job training, education, and, ultimately, productive employment. The President and I have pledged to strengthen child support enforcement, improve family support services, and to end welfare as we know it.

I want to take this opportunity to reiterate that this Administration is committed to reforming our welfare system. However, we must undertake health care reform first. A new health care system is a precondition to moving all families to self-sufficiency. Our goal is to change the welfare system to empower Americans to improve their lives and the lives of their children.

In the near future, the President will announce a task force on welfare reform to develop strategies to meet the following four goals:

*Ensuring that full-time workers with families do not have to raise their children in poverty;

*Holding absent parents financially responsible for their children;

*Providing people who can work with the training and support they need to move off of welfare; and

*Making cash welfare a transitional program.

We believe that real welfare reform involves changes in a range of federal policies and programs. President Clinton's economic plan addresses some of those changes by including proposals designed to make work pay. For example, the plan proposes to expand the Earned Income Tax Credit to ensure that a family of four will not be forced to live below the poverty level if one of the parents works full time at a minimum wage job.

The President's plan includes both investments and deficit reduction measures in specific programs of the Administration for Children and Families (ACF). Two investments will be directed toward further strengthening American families. The first is for parenting and family support services. The second investment contains monies for the Child Care and Development Block Grant. This investment will provide additional resources to help low income families who need child care services.

The first ACF deficit reduction measure involves eliminating the enhanced Federal funding matching rates offered to States for many years as incentives to carrying out special Aid to Families with Dependent Children (AFDC) administrative activities. We propose to bring these incentive match rates back to 50 percent-the normal match rate for State administration of the AFDC program. Similar policies also will apply to the Medicaid and Food Stamp programs.

Secondly, the President has enunciated some immediate actions which can be taken to strengthen the enforcement of child support and add to the overall goal of deficit reduction. Specifically, President Clinton has identified Federal savings that will be achieved through several program enhancements. These efforts would also serve to support and complement long-range reforms to child support enforcement that will be put forth by the welfare reform task force.

Social Security

The twin goals of investment and deficit reduction will be pursued in the largest Federal program of all, Social Security. President Clinton proposes stimulus monies and long term investments in the efficiency and services of the Social Security Administration (SSA). The President's Fiscal Year 1993 Supplemental Budget Request includes monies to process the backlog of disability claims, SSA's most critical problem, and to improve automation and infrastructure.

Multi-year investments will be used to continue the critical modernization of SSA. This investment will permit a long-needed computer system redesign and lay the groundwork for the automation systems that will be necessary to handle the increased number of claims expected when the "baby boom" generation retires.

President Clinton proposes that the Social Security Administration's contribution to deficit reduction will come in two ways. First, the plan will increase the percentage of

taxable Social Security benefits for individuals who are already taxed. I want to emphasize that this will not increase the number of people paying taxes on their Social Security benefits. Only those with higher incomes, who already pay some taxes on benefits, will have those taxes increased.

Second, the President proposes charging a fee to States for which SSA administers a State supplement of the Federal Supplemental Security Income (SSI) program. Many States have eligibility requirements that are different from those for the Federal SSI benefit, making determinations complex and costly for SSA to manage. Regardless of the complexity of State rules, the Federal government incurs costs for all States for which it administers the State Supplement, and it is not unreasonable to ask States to assume part of these costs.

Conclusion

President Clinton's economic package provides a strong foundation for our national prosperity by stimulating the economy, investing in our future, and reducing the deficit. Our impending health care reform package and our future welfare reform actions will build upon this foundation.

Mr. Chairman, I look forward to working closely with this Committee as we move through the budget reconciliation process, strive for health care and welfare reform, and develop subsequent initiatives to improve the lives of all Americans. I will be happy to answer any questions you may have.

ATTACHMENT

FOR THE TESTIMONY OF

DONNA E. SHALALA

SECRETARY OF HEALTH AND HUMAN SERVICES

PROPOSALS

MEDICARE - PART A

1. **Extend the 10% Reduction Hospital Capital Payments**

Under current law, Medicare payments for hospital capital under both Part A (inpatient) and Part B (outpatient) are reduced by 10 percent, through FY 1995. This proposal would permanently extend that 10% reduction. Paying hospitals less than their full cost of capital provides a strong incentive to evaluate the need for capital investment and thus places an important brake on the unnecessary proliferation of plant and equipment. In addition, hospital occupancy rates have averaged below 70% for several years; Medicare should not subsidize this excess capacity. This proposal is consistent with the Department's Inspector General recommendations.

Savings (in millions)

	FY 1994	4-Year Total
Part A	$0	$680
Part B	$0	$260

2. **Set the PPS Hospital Update at Market Basket Minus 1% in FY 1994 and FY 1995**

This proposal would continue the current practice of setting hospital updates below the market basket rate of increase by setting the update at the market basket rate of increase minus one percentage point for each of FYs 1994 and 1995. Maintaining an update less than the full market basket rate of increase provides continuing incentives for hospitals to increase efficiency in operations. It would also offset a previous forecast error. This reduction is consistent with the recommendation Prospective Payment Assessment Commission (ProPAC) is expected to make for FY 1994.

Savings (in millions)

FY 1994	4-Year Total
$550	$5,190

3. Move the Annual Changes in the Prospective Payment System (PPS) Updates to January 1 of Each Year, Beginning with FY 1994

Under current law, the annual PPS changes and updates become effective each year on October 1, absent Congressional action. This proposal would move the effective date for annual PPS changes to January 1, to conform to the January update cycle for most of the Medicare program. In addition, a definite January 1 date would alleviate the uncertainty and disruption which occurs when the Congressional legislative cycle goes beyond October 1.

Savings (in millions)

FY 1994	4-Year Total
$1,000	$4,610

4. Phase In a Reduction in the IME Payment Adjustment Ratio

Under current law, Medicare pays hospitals for its share of the indirect medical education (IME) costs associated with the use of interns and residents. The IME payment factor is derived from a formula that relates operating costs per case to the intensity of the hospital's teaching program. This proposal would alter the adjustment formula to reduce the extra payment amounts beginning in FY 1996. Numerous studies by HCFA, the Prospective Payment Assessment Commission (ProPAC), the GAO and the IG show that the current adjustment formula overstates the increase in costs resulting from the presence of interns and residents.

Savings (in millions)

FY 1994	4-Year Total
$0	$1,940

5. Reform Medicare Payments for Direct Medical Education Costs

Under current law, Medicare payment for the direct costs of graduate medical education (GME) are based on each hospital's per resident costs. This proposal would base GME payments on a national average per resident amount, and would give greater weight to primary care residencies. Using national averages would address present inequities in direct GME payments, whereby some providers are paid five times as much per resident as others. Moreover, this proposal would provide an incentive for programs to recruit and train primary care residents.

Savings (in millions)

FY 1994	4-Year Total
$350	$1,360

6. Eliminate Add-on for Hospital-based Home Health Agencies (HHAs)

Under current law, hospital based home health agencies (HHAs) receive an upward adjustment to their per-visit cost limits. This proposal would eliminate this adjustment, making freestanding and hospital-based HHAs subject to the same cost limits. The current adjustment is not necessary; roughly half of hospital-based HHAs do not exceed the cost limits for freestanding clinics. Eliminating the adjustment would provide incentives for the remaining hospital-based HHAs to become more efficient, and would level the playing field so that hospital-based HHAs do not have a competitive advantage over freestanding HHAs.

Savings (in millions)

FY 1994	4-Year Total
$160	$840

7. Eliminate Return On Equity Payments to Proprietary Skilled Nursing Facilities

Proprietary Skilled Nursing Facilities (SNFs) are the only remaining category of providers that receive payment for Return on Equity (ROE) from Medicare. Non-proprietary SNFs do not receive ROE payments. This proposal would eliminate Medicare ROE payments to proprietary SNFs, thus creating fair competition between SNFs.

Savings (in millions)

FY 1994	4-Year Total
$110	$560

MEDICARE - PART B

1. Maintain Part B Premium as Proportion of Program Costs

Under current law, the amount of the Part B premium is set in law through 1995. The premium amounts were set by Congress in OBRA 90 so as to finance approximately 25 percent of program costs through premium collections. After 1995, the premium will be indexed to the previous year's Social Security increase. Program costs will be reduced by the enactment of proposals in this budget. This proposal would maintain the premium in 1996 and 1997 roughly at the proportion of FY 95 program costs. This would result in somewhat higher premiums than current law for 1997 and thereafter.

Savings (in millions)

FY 1994	4-Year Total
$0	$5,015

2. Increase Hospital Outpatient Cut

Currently, certain outpatient services are paid at 94.2% of costs. This proposal would extend that reduction and would further reduce the level to 90% of costs beginning with services rendered during fiscal years 1996 and thereafter making the reduction consistent with the reduction in payment for outpatient capital.

Savings (in millions)

FY 1994	4-Year Total
$0	$1,640

3. Reduce Payments for Clinical Laboratory Services and Adjust Fees for Market Factors

This proposal would limit the Medicare Part B laboratory fee schedule to 76 percent of the median of all fees. This revised fee schedule would be updated annually by 2 percent-- an extension of the current law established in OBRA-90. Finally, based on market surveys, the Secretary of HHS would make additional adjustments in Medicare rates to laboratories to reflect technological changes and other factors. Studies indicate that Medicare payments to laboratories are excessive, and they should more closely reflect decreased costs attributed to technological advances such as increased automation, and changes in the market, such as lower cost equipment.

Savings (in millions)

FY 1994	4-Year Total
$420	$3,830

4. Reduce Physician Fees in 1994 Except Primary Care

For FY 1994, this proposal would give the full physician fee schedule update for primary care services, and approximately two percentage points less than the full update for all other services. Medicare spending on physicians increased extensively during the 1980s.

Savings (in millions)

FY 1994	4-Year Total
$200	$1,250

5. <u>Resource-Based Practice Expenses Phase-In</u>

This proposal would phase-in to a resource-based system for practice expenses under the physician fee schedule beginning in 1997, a suggestion made by the 1993 Physician Payment Review Commission. As an interim step toward such a system, this proposal would reduce practice expense relative value units in 1994, 1995 and 1996. A cushion on reductions would be provided while the methods and details to implement a full resource-based system for practice expenses are developed between now and 1997.

Savings (in millions)

FY 1994	4-Year Total
$100	$2,025

6. <u>Reduce Physician MVPS and Update "Default" Formulas</u>

This proposal refines the method by which Medicare increases payments to physicians. If Congress does not set the rate of increase in Medicare physician expenditures (the Volume Performance Standard) or the update, a default formula specified in law automatically applies. This proposal would reduce the target for FY 1994 and thereafter by reducing the amount that the default formula would allow. The proposal would similarly reduce the formula for the default update.

Currently there are only modest reductions in this rate of growth. This proposal would lower the rate of growth to be more in line with recommendations made by the Physician Payment Review Commission.

Savings (in millions)

FY 1994	4-Year Total
$0	$850

7. <u>Bundle Inpatient Radiology, Anesthesia and Pathology Payments</u>

Medicare payments for radiology, anesthesia and pathology services provided in the hospital setting would be bundled into the DRG. Payment would be made to the hospital or to its medical staff which would then make payments to individual physicians. Beneficiary coinsurance would be 20 percent of the bundled payment.

Bundling payment for inpatient radiology, anesthesia and pathology services is a structural reform that deals with the total expenditures of these services, rather than on the fee for each specific service. This approach would give physicians and hospitals incentives to be cost-conscious, provide only medically necessary services and eliminate the provision of marginal services.

Savings (in millions)

FY 1994	4-Year Total
$0	$390

8. <u>Single Fee For Surgery</u>

Under this proposal, Medicare would make the same payment for a surgical procedure regardless of whether the primary surgeon used an assistant-at-surgery, a practice that varies greatly throughout the country. Medicare payment for the primary surgeon would be reduced by the amount of any separate payment for assistant-at-surgery used by the surgeon. Exceptions would be allowed if necessary for particularly difficult cases.

Data on extensive geographic variation in use of assistants-at-surgery and extensive use of primary care physicians as assistants strongly suggests that use of assistants-at-surgery is related to practice styles of individual surgeons and customary patterns in local areas, rather than the characteristics of specific patients (such as severity). This proposal would create a level playing field between surgeons who do and do not use assistants-at-surgery.

Savings (in millions)

FY 1994	4-Year Total
$50	$380

9. <u>Physician Ownership and Referral</u>

Physicians cannot refer a Medicare patient to a clinical laboratory in which the physician, or the physician's relative, has a financial relationship. This proposal would extend ownership and referral prohibitions to additional services such as: physical and occupational therapy; radiology and other diagnostics; radiation therapy; durable medical equipment, parenteral/enteral nutrition equipment and supplies. Various studies have demonstrated that physicians who have ownership interests make referrals at a higher rate than non-owners. The extension of the referral ban should help to reduce unnecessary utilization of services.

Savings (in millions)

FY 1994	4-Year Total
$0	$250

10. <u>Electronic Billing Incentive</u>

This proposal would create an incentive to encourage submission of Medicare Part B claims via electronic format by charging $1 per paper claim beginning January 1, 1996. This incentive is critical to containing and lowering Medicare administrative costs. The lead time will give physician and suppliers time to adjust their systems or arrange to purchase electronic billing services.

Savings (in millions)

FY 1994	4-Year Total
$0	$265

11. <u>DME Proposals</u>

Payment for durable medical equipment (DME) is based on carrier fee schedules with national limits at the average value across all carriers. Payment for DME would be reduced by: tightening the national limits; reclassifying certain items; restoring Medicare's contractors authority to make adjustments to the fee schedules if the payments amounts are grossly excessive or deficient based on current price information; and giving Medicare's contractors flexibility to require that the medical need of an item be demonstrated in advance of delivery to the patient.

In addition, the fee schedule for prosthetics and orthotics would be tightened by using the DME payment rules with the national median as the limit. Finally, the budget proposes to establish a fee schedule to pay for parenteral and enteral nutrients and supplies, and to pay for parenteral and enteral equipment under the same fee schedule and methodology used for DME.

These proposals as a package will reduce excessive variation in payment amounts and strengthen administration of the DME benefit.

Savings (in millions)

FY 1994	4-Year Total
$75	$510

12. Set EPO at Non-U.S. Market Rates ($10 per 1,000) Units

Under current law, Medicare pays $11 per 1,000 units of EPO. Under this proposal, that amount would be reduced to $10 per 1,000 units of EPO.

Unlike other drugs in the medical marketplace, only one pharmaceutical company manufactures EPO, and Medicare purchases 90 percent of EPO supplies. This lack of competition in the marketplace has grossly inflated the cost of EPO and has contributed to consistent price increases over time.

The proposed payment amount would reduce the disparity between Medicare's current reimbursement rate and the actual cost that facilities pay for EPO, based on recent findings from the Department's Inspector General.

Savings (in millions)

FY 1994	4-Year Total
$30	$160

MEDICARE - PART A & B

1. **Extend IRS/SSA/Data Match**

OBRA 89 created a program for using data available to the government in conjunction with questionnaires to employers to identify situations where Medicare made a mistaken primary payment rather than the secondary payment required under the law for certain beneficiaries. This program is expected to lead to the recovery of billions of dollars of mistaken payments. This proposal would extend the authorization of the data match through 1998.

Savings (in millions)

FY 1994	4-Year Total
$0	$165

2. **Extended Provision Requiring Secondary Payment for Certain Disabled Beneficiaries**

Under current law, Medicare makes a secondary, rather than primary, payment for disabled beneficiaries who have health coverage through certain employer group health plans. This results in savings to the program and allows Medicare dollars to be spent on services for individuals who do not have employment related health insurance coverage. The authority for this provisions expires at the end of fiscal year 1995. This proposal would make the authority permanent.

Savings (in millions)

FY 1994	4-Year Total
$0	$1,610

3. <u>Extended Provision Requiring Secondary Payment for Certain Beneficiaries with End Stage Renal Disease (ESRD)</u>

Under current law, Medicare makes a secondary, rather than primary, payment for beneficiaries with ESRD who have health coverage through a group health plan. Medicare makes these secondary payments for the first 18 months of entitlement. After this 18-month period, Medicare makes primary payment. As with the provision related to the disabled described above, this policy results in savings to the program. The authority for this provision expires at the end of 1995. This proposal would make the authority permanent.

Savings (in millions)

FY 1994	4-Year Total
$0	$70

4. <u>Medicare Secondary Payor Reforms</u>

Under current law, Medicare is the secondary payor for certain beneficiaries with coverage through group health plan. Rules for determining whether a beneficiary is subject to these provisions differ depending on whether the beneficiary is aged, disabled or has ESRD. This proposal would make all of the employer thresholds consistent with the aged provisions (employers of 20 or more). The threshold for disability provision would be reduced from 100 to 20 and a threshold would be created for beneficiaries with ESRD (currently there is none). In addition, the provisions for the disabled would be liberalized to tie directly to employment status as is the case with the aged provisions. Finally, the exemption from the MSP provisions for persons with ESRD who are also aged or disabled would be eliminated. Payments for these individuals would be treated the same as with payment for beneficiaries entitled to Medicare solely because of ESRD. These provisions will simplify the Medicare Secondary Payor program and generate budget savings. In addition to these changes to simplify the MSP program, the budget includes a number of minor proposals to strengthen program administration.

Savings (in millions)

FY 1994	4-Year Total
$127	$947

MEDICARE AND MEDICAID

1. Third Party Liability

This proposal would remove many of the structural impediments hindering proper identification and billing of third party liability (TPL) by: 1) requiring employers to report employment based health coverage data annually on the W-2; 2) granting access to this data to all federally-assisted and financed health programs (Medicare, Medicaid, Veterans Affairs Health, CHAMPUS, and others); 3) reinforcing existing coordination of benefits (which payer pays and in what order) laws and regulation; and 4) removing impediments that hinder States from collecting from private insurers.

Savings (in millions)

FY 1994	4-Year Total
$0	$800

HUMAN SERVICES

1. **Low Income Home Energy Assistance**

An additional $3 billion in funds in FY 1995-1998 will be requested to alleviate the impact of the energy tax increase on low income households. LIHEAP funds help low income households to meet the costs of home heating and cooling needs, deal with energy-related crises and pay for energy-related repairs to make their homes more energy efficient.

2. **Child Care and Development Block Grant (CCDBG)**

To support low income families who need child care to work, the President's Budget includes an additional investment of $40 million in FY 1994 and $795 million over five years for CCDBG.

3. **Parenting and Family Support**

$60 million in FY 1994 ($1.7 billion over FY 1994-1998) will be set aside to respond to sensitive, emerging issues in parenting and family support, including activities that would help disadvantaged parents work with their children at home.

4. **Child Support Enforcement**

Expanded child support activities including those in _Putting People First_ and many of the Interstate Commission on Child Support recommendations -- for example, creation of a national data bank identifying non-custodial parents who are not making required payments for their children, reporting the names to credit bureaus, using IRS to assist in collection of seriously overdue child support, and paternity establishment at birth for all children. The proposals are targeted to produce billions of dollars in increased child support collections and medical support. Federal savings are currently estimated at $27 million in FY 1994 and $505 million over FY 1994-1998.

5. **Medicaid and AFDC State Administrative Expenses**

Beginning April 1, 1994, match all Medicaid and AFDC state administrative expenses at 50 percent. Food Stamps match rates would also be set at 50 percent. Limited hardship waivers will be available. Savings are $200 million in FY 1994, and $2.4 billion over five years.

SOCIAL SECURITY ADMINISTRATION (SSA)

1. Disability Insurance Processing

This proposal would provide $302 million in FY 1993 to help SSA prevent further delays in processing of disability insurance claims, review cases earlier, and make other improvements in the delivery of services. There has been a dramatic increase in Social Security and Supplemental Security Income (SSI) disability claims in recent years, and tremendous backlogs have resulted.

Cost (in millions):
FY 1993 - $302
FY 1994 - $120
4 year total - $720

2. Modernizing SSA Computer Systems

SSA relies heavily on its information systems to provide services and pay benefits. To meet current and future demands, SSA and State Disability Determination Services (DDSs) must abandon their labor-intensive, paper-driven tradition, and automate. The proposal would invest in pilot-tested Intelligence Workstations and Local Area Networks (IWS/LAN), creating a state-of-the-art, computing network for all of SSA and the DDSs. The funding provides for modular workstations, design and site preparation, and installation.

Cost (in millions):
FY 1994 - $145
4 year total - $880

3. SSA Fee for State SSI Administration

This provision would charge the States a small fee for the cost of Federal administration of State supplements to the Federal SSI benefit.

Saving over 4 years: $520 million

4. <u>Conform Taxation of Benefits to Private Pensions</u>

Up to 50 percent of Social Security (and Railroad Retirement Social Security Equivalent Benefits and Railroad Retirement) benefits are currently taxed for those recipients with income exceeding thresholds of $25,000 for individuals, and $32,000 for couples. This proposal would tax up to 85 percent of benefits for those exceeding the thresholds. This would make the treatment of Social Security benefits more consistent with that of private pensions which, under current law, are subject to taxation once benefits exceed the individual's contributions.

Extending this approach to Social Security without maintaining current income thresholds would make benefits taxable for nearly all recipients. By maintaining the existing income thresholds, most low and middle-income beneficiaries will continue to be exempted from benefit taxation.

Savings (in billions):

FY 1994 - $2.7
4 year total - $21.4

Chairman ROSTENKOWSKI. Madam Secretary, as you may know, there are many inner city hospitals serving poor and uninsured patients. Many of these are public hospitals, and many are in poor financial condition. Medicare supports these hospitals through both the disproportionate share adjustment and the indirect medical education, or IME, adjustment.

Hopefully, health care reform will provide more direct support by creating universal coverage for all patients. However, in the meantime, what I am concerned about is the effect of the President's proposed cuts in indirect medical education will have on these institutions. Wouldn't it be better to hold the IME reductions until we can provide for universal coverage? And how can we be sure that the safety net function performed by these institutions will not be unduly harmed by these reductions?

Secretary SHALALA. Mr. Chairman, I do share your concern about inner city teaching hospitals. We do not believe that our proposals will be too burdensome. We base them on the Prospective Payment Assessment Commission—ProPAC—recommendations. In fact, the adjustment that we recommended is less than those proposed by ProPAC. We have not touched the disproportionate share adjustment for these hospitals, only adjusted that related to the data on teaching. If your committee had recommendations that would substitute for this, we would be happy to consider them and happy to work with you.

Chairman ROSTENKOWSKI. Thank you, Madam Secretary.

Mr. Archer will inquire.

Mr. ARCHER. Thank you, Mr. Chairman.

Madam Secretary, I know from the discussion we already had that you are a great believer in a cost-benefit relationship for the dollar spent, and I applaud that.

The President wrote in his economic package that children who participate in Head Start do better in school and become more productive adults. In his speech to Congress he said that Head Start returns $3 for every dollar invested. I was fascinated yesterday that, since his speech to Congress—Dr. Tyson informs us that it has increased from $3 to $6, that there is a $6 return for every dollar invested. So if we wait just a few more weeks we might get that up to really some proportional figures. I am curious if you agree with these claims.

Secretary SHALALA. I agree that investment in Head Start saves us money in the long run. Obviously, there are a range of studies in terms of how much we actually save. I think I would feel safer at the $3 number. Though, there are studies that certainly would justify thoughtful people coming to a conclusion about larger numbers.

I think the important thing about Head Start is, as part of an early investment strategy in our youngest children, when you put together immunization, prenatal and perinatal care programs, and Head Start, particularly for the least advantaged in our society, these kinds of programs in combination do have an impact on young people's lives, do make a difference and do reduce our costs in the long run.

Mr. ARCHER. Can you tell the committee the citation of the specific studies that you refer to?

Secretary SHALALA. I would be happy to provide those for the record.

Mr. ARCHER. I know you have some of your staff people here. Could you give those to me at this time?

Secretary SHALALA. I don't know whether we brought them with us. The $6 number comes from the Ford Foundation study of the preschool program. And I don't know where the $3 number comes from, but that is the number I have been using. We will provide you with the other citations and with the citations on the success of the Head Start program.

Mr. ARCHER. Is that the Perry Preschool Program study?

Secretary SHALALA. I think it was a study of a number of preschool programs.

Mr. ARCHER. Is that the one called the Perry Preschool Program?

Secretary SHALALA. I know the Perry Preschool Program, but I think that—in fact the Perry Preschool Program longitudinal study suggested that $7 was saved for every $1 invested.

Mr. ARCHER. Madam Secretary, are you aware that neither of those studies dealt with Head Start students?

Secretary SHALALA. I am aware that those studies and many of the studies on preschool programs are modeled—that the Head Start program is modeled on some of those programs. I am aware that some of the programs that have been studied were more enriched that some of our Head Start programs.

I think what the studies suggest to us is, to really get significant savings for dollars, that the new resources we put into the Head Start program must both expand the program in terms of both the hours during the day and in the summer, to have a greater impact, but, more importantly, must strengthen the quality of the programs, including the quality of the teachers, the facilities, and the training for the people that work with the children.

Mr. ARCHER. Well, one of the things that bothers me is, being a strong advocate of benefits that are in excess of costs, that we don't, apparently, have any studies of Head Start programs that are definitive. I am sure you are aware that the last definitive study that we had was done by HHS in 1985 which reviewed all of the research that had been done on Head Start programs. And I am sure you are also aware that it concluded that the performance data that was submitted was not reliable. That was the conclusion of the last comprehensive review of Head Start studies.

The review was called the Impact of Head Start on Children, Families and Communities, and it showed that within one or two years there was a fade-out as to the benefits that had occurred with the children. According to the review there were no studies of impact on teen pregnancy, juvenile delinquency, employment, or welfare use by Head Start recipients. It found no benefit cost studies of Head Start.

Secretary SHALALA. Congressman Archer, I am well aware of the weakness of the research over the last 10 years in the Department of Health and Human Services on these programs. But I am also aware that other scholars have concluded quite convincingly, including some of the Nation's leading scholars who have recently sent a letter to Congress on this subject, that believe very strongly that investments in these early and preschool programs are impor-

tant contributions to the success of younger children. They come to this conclusion from a variety of studies, not simply studies directly on Head Start, but a variety of studies of young children and what young children need.

Mr. ARCHER. Well, again, if we are going to spend billions and billions of dollars funding this program, it seems that we should have some definitive data on Head Start, not theoretical conclusions that are based on any number of studies that have nothing really to do with Head Start. That is a matter of great concern to me.

Professor Zigler, who is considered by most to be the father of this program, has said that the results and the operations were so uneven in Head Start that 30 percent of them ought to be canceled.

Now, the President is coming before the Congress with a multibillion dollar full funding approach which I believe from our colloquy is not supported by any specific research on the effectiveness of Head Start itself.

Secretary SHALALA. I would not come to the same conclusion that you do.

First of all, I might point out that Professor Zigler supports the expansion and the strengthening of the Head Start program. That was the letter I referred to in my opening statement.

Second, there have been studies since then. A Philadelphia study suggests the longer-term effects on grade retention and fewer children in special classes. This is another study of Head Start, and we would be happy to provide with you a citation on it.

Mr. ARCHER. Where was that study done?

Secretary SHALALA. In Philadelphia.

Mr. ARCHER. Just in the City of Philadelphia?

Secretary SHALALA. It must be. Yes.

Mr. ARCHER. I believe the answer is yes, it was done only in Philadelphia. As I understand it, there were no benefit cost figures established by that study.

Secretary SHALALA. I can't——

[The following was subsequently received:]

HEAD START: WHAT THE RESEARCH SHOWS

BACKGROUND

Head Start programs provide comprehensive child development, educational, health, nutritional, social and other services to predominantly low-income preschool children and their families. In recognition of the important role parents play in their child's development, Head Start programs are required to provide for the direct participation of parents in the development, conduct, and direction of local programs.

Proposals to accelerate Head Start expansion in the coming years have led to renewed interest in research findings regarding the program and its benefits. The discussions below first summarize the overall research findings regarding the immediate, medium-term, and long-term benefits of Head Start and then discuss the specific findings of several of the more prominent studies regarding the program. Findings regarding several non-Head Start preschool programs are also described, and conclusions are drawn regarding the benefits of Head Start programs.

Most studies regarding Head Start, particularly in its early years, focused primarily on the cognitive/intellectual aspects of the program, as manifested in children's I.Q. scores and school achievement tests. Policy debates have focused on intellectual benefits as well. While this domain is important, studies and policy discussions focusing only on cognitive issues have ignored many benefits of the Head Start program such as those resulting from the health/nutrition, social services, and parent involvement components.

Concerns have been expressed about claims that Head Start saves money in the long term. It has been noted that the particular study showing cost savings was not of the Head Start Program; instead it was of a more intensive program known as the High/Scope Perry Preschool. In addition, confusion has resulted from the variety of cost-benefit figures have been cited, ranging from \$3 to \$6 saved for every dollar invested. These figures all come from the High/Scope Perry Preschool study. At different points during the study (which at this point has continued nearly 25 years) the investigators made different estimates of the benefits of the program. As each new wave of data has been collected, the authors have recalculated the benefits estimated (Berrueta-Clement, et. al, 1984; Weikart, 1989). There have been no cost-benefit studies specifically performed on Head Start. However, the evidence cited below summarizes what research demonstrates about the beneficial effects of Head Start programs (e.g. children being more likely to be promoted in school and less likely to be assigned to special education classes).

OVERALL RESEARCH FINDINGS ON HEAD START

- **School Readiness -- Immediate Positive Gains**

Studies are virtually unanimous in finding that Head Start has immediate positive effects on the status of children. These effects include improved results in cognitive test scores, socioemotional test scores and health status. Head Start children are more ready to start school than their peers and are at an advantage in terms of social behavior, achievement motivation and self esteem (McKey, et. al., 1985; Fosburg, et. al., 1984).

In addition to the program's effects on children, Head Start also helps their families and communities. On top of direct effects from employment (over 35% of the program's paid staff are parents of current or former Head Start children), the parents of Head Start children show improved psychological well being and somewhat decreased family dysfunction (Leik & Chalkey, 1989; Parker, et. al., 1987; Mann, et. al., 1976). Also, according to the 1985 Head Start Synthesis Project, Head Start "has been associated with positive changes (which) usually result in increased and more comprehensive social and health services for the poor and in more responsive educational programs" in the communities where Head Start programs are located.

- **Medium-Term Findings -- The Elementary School Years**

A number of studies have found that Head Start children are more likely to be promoted to the next grade in school, have better attendance and are less likely to be assigned to special education classes than non-Head Start children (Royster, 1977; Shipman, et. al., 1976; Monroe and McDonald, 1981; Goodstein, et. al., 1975). However, some studies also show that the immediate cognitive gains children make during the Head Start program (as with other preschool programs) may "fade out" over time. Most medium-term findings are based on cross-sectional rather than longitudinal studies and most of these studies did not have comparable control groups (McKey, et. al., 1985). In addition, those studies finding decreasing cognitive advantages may reflect the lack of appropriate follow up in the schools.

Indeed, "[t]he same fade out of intellectual gains found for Head Start programs...was also found for the High/Scope Perry program. Nevertheless, the children of the High/Scope Perry program went on to achieve dramatic long-term, real-life outcomes -- including significant improvement in school achievement years later, a significantly lower high school dropout rate, and significant reductions in arrests for delinquency and crime" (Schweinhart and Weikart, 1993).

When thinking about research on Head Start, it is important to recognize that Head Start is a comprehensive program designed to benefit children and families in a variety of domains. To look only at children's cognitive achievement is to miss much of Head Start's strength. More lasting than cognitive test scores are the achievements in children's social functioning in a school setting.

- **Long-Term Outcomes -- Little Data**

The study most often cited for showing large potential long term gains for children is that of the High Scope Foundation's Perry Preschool in Ypsilanti, Michigan. This was not a Head Start program. While the gains into adolescence were very impressive, the Perry Preschool Program provided more costly, intensive services for children over a two-year period. There are no studies which examine similar issues (for instance, adolescent pregnancy and youth unemployment) for former Head Start children. None of the cost benefit studies (those finding several dollars of future savings for each dollar spent on preschool services) deal with Head Start programs.

<u>SPECIFIC FINDINGS OF PROMINENT HEAD START EVALUATIONS</u>

- **The Westinghouse Study, 1969**

In 1969, the Westinghouse Learning Corporation completed the first major evaluation of Head Start. **Summer programs were found to have no lasting impact. Full year programs resulted in cognitive and language gains at the first grade level but appeared to "fade out" by second or third grade. Gains were particularly noteworthy among African American children and among children attending Head Start in central cities and in the Southeast.**

This study has been criticized for having a faulty design, leading to biased results. First of all, the comparison group selected may not have been as disadvantaged as those in Head Start. Consequently, the impact of Head Start may be systematically underestimated. Second, the design did not control for environmental circumstances -- either at home or at school -- leading to uncertainty as to whether short-lived child outcomes truly reflect the effects of Head Start or reflect subsequent effects of the home and school environments. In addition, this study did not evaluate the health and nutritional components of Head Start programs, nor did it assess the effects of parental involvement in Head Start on parent outcomes. Yet these components are as integral to the Head Start program as is the education component. Consequently, this study yields incomplete information on Head Start's effectiveness.

- **Head Start Synthesis Project, 1985**

There has not been a major evaluation of the Head Start program since the Westinghouse study. However, there have been many small evaluations of selected aspect of various Head Start programs across the country. Despite the wide array of research designs, sample sizes, and outcome measures used, a "meta-analysis" was conducted in 1985 to glean basic findings from these diverse studies. This "Head Start Synthesis Project" reviewed over 210 reports of research on the effects of local Head Start programs and found that Head Start results in **"significant, immediate gains in cognitive test scores, socio-emotional test scores, and health status, (though) in the long-run, cognitive and socio-emotional test scores of**

former Head Start students do not remain superior to those of disadvantaged children who did not attend Head Start" (McKey, et. al., 1985). A subset of these studies found former Head Start children were more likely to be promoted to the next grade and less likely to be assigned to special education classes. These studies suggest that Head Start children have developed the necessary social competencies to adapt more readily to their school environment and experience more "real life" academic success than their no-treatment peers (Cawly and Goodstein, 1966; Bee, 1981; Shipman, 1976; Hebbler, 1981).

Unlike the Westinghouse study, this synthesis project did evaluate the health and nutrition components, and found that "Head Start is very successful in improving the general health of the children in serves, providing needed health care, and improving existing health care within communities (though) it appears less successful in its health education efforts and in its efforts to influence home health practices."

In addition, this synthesis explored the effectiveness of parental involvement and found "evidence that parents who actively participate in the program have high levels of psychological well-being, improve their economic and social status, and have children with high levels of developmental achievement." Unfortunately, the study found that it is usually the same small number of parents who actively participate on an ongoing basis. Furthermore, parent education programs designed to influence child-rearing practices in the home have had mixed results.

Finally, the synthesis study assessed the effect of Head Start on communities and found "Head Start has been associated with positive changes (which) usually result in increased and more comprehensive social and health services for the poor and in more responsive educational programs. Greater visibility and greater parent participation both increase the effectiveness of a local Head Start program in affecting community institutions." Based on these findings, this study recommended more extensive collaboration with the public schools to bridge the "discontinuity in educational approaches between Head Start and public schools."

This synthesis has been criticized, mainly for its use of meta-analysis. This technique of standardizing findings across many studies of various designs may have the tendency of minimizing the results found in specific studies. Because it may "over-aggregate" results, studies using meta-analysis may conceal more distilled findings. But since this is likely to have the effect of underestimating effects, Head Start children may be doing even better than these results suggest.

- **Path To the Future: Long-term Effects of Head Start in the Philadelphia School District**

This 1987 study used ten years of data on almost 15,000 children who attended Philadelphia Follow Through programs in 33 schools in the city's school district. (The Follow Through program serves children from kindergarten through third grade.) Since enrollment in Head Start is not a prerequisite for enrollment in Follow Through, this data included some children who had not attended Head Start.

Results indicate that Head Start children more often avoided serious school problems, were less frequently retained in grade from kindergarten through sixth grade, had better attendance rates and lower attrition than non-Head Start children. Head Start children performed slightly (but non-significantly) better on achievement tests than their non-Head Start peers up to third grade, but there was no difference on achievement test scores from third to sixth grade (Copple, Cline, & Smith, 1987).

The Philadelphia data is based on a large number of children and schools, collected over a long period of time, and represents typical Head Start programs more accurately than the samples in previous large-scale studies. Unfortunately, the outcomes measured related only to school success and not to any of the more comprehensive goals of the Head Start program. In addition, the Philadelphia data base is -- in a statistical sense -- a "noisy" one: varied record-keeping over the ten years of data collection and policy changes during this period increases the variability in the data. Increased variability tends to depress the real magnitude of effect size. However, this suggests that any findings are likely to underestimate the true effects of Head Start, and the detection of statistically significant effects should be taken seriously.

- **Program Model Effects Study**

This 1987 study compared the relative effects on parents and children of three different Head Start delivery models (center-based, home-based, and a combination of center and home-based) of a grantee in rural Pennsylvania. Outcomes were measured from the time the children were enrolled in Head Start through kindergarten.

No difference was found in children's cognitive development across the three delivery models. Parents enrolled in the home-based model demonstrated greater gains in academic stimulation of their children; in the use of toys, games and reading material; and in encouraging their children to learn. Home-based parents also demonstrated greater growth in knowledge of child development and parent empowerment (University of Delaware, 1988).

- **Oregon Longitudinal Study**

This 1989 study is assessing former Head Start children, currently in kindergarten through fifth grade, on academic performance and placement indices. Results show that **former Head Start children performed at grade level on achievement tests in reading, math, and language use in grades 3-5. In addition, former Head Start children were more likely to be enrolled in "gifted and talented" programs than their non-Head Start peers. Finally, former Head Start children were less likely to be enrolled in special education classes than the district-wide average enrollment rates** (Norris, 1989).

- **Head Start Family Impact Study**

This 1988 study evaluated the effect of two different Head Start interventions on family functioning. Eighty-one children enrolled in a Minnesota Head Start program were divided into two groups: one group remained enrolled in the current Head Start program, and the other group experienced an "enhanced" program with intensive parent involvement. Parents in the enhanced program were involved in learning activities with their children 2-3 times as often as parents in the "regular" Head Start program. Family functioning, as measured by the FACES III (Family Adaptability and Cohesion Evaluation Scales) instrument, was assessed for both treatment groups and a control group, made up of 21 children on the Head Start waiting list.

Results indicate that family dysfunction scores diminished significantly for families in the "enriched" program, and diminished somewhat for families in the regular Head Start program, compared to control group families. In addition, mothers in both Head Start groups were more likely to assess their child as competent -- and were more competent themselves -- compared to control group mothers (Leik and Chalkey, 1989).

SPECIFIC FINDINGS FROM OTHER PRESCHOOL EVALUATIONS

- **Consortium for Longitudinal Studies, 1982**

The Consortium was formed to combine the projects of 12 researchers who had conducted preschool programs in the 1960s. a follow-up study using common measures was conducted in 1976-1977. Program design and curricula varied; included were both home-based and center-based programs. The 3,700 program participants were poor and minority families, with a heavy representation of black families. Children ranged from age three months to five years at the time of program entry. By the time of the Consortium's follow-up they ranged in age form 9 years to 19 years.

Researchers found positive results from preschool attendance. Children who participated in preschool programs were more likely to succeed in school as measured by staying on grade level with their peers and avoiding inappropriate placement in special education classes.

Lasting gains in academic achievement tests (particularly mathematics) were noted. However, intelligence gains (as measured by IQ tests) faded three years after the program had ended. In addition to these cognitive impacts, there were signs of favorable impacts on the child's self-concept, parental aspirations for the child's education, and on a family's achievement orientation. Parent participation was extremely high (reviewed in Collins, 1989).

These studies each employed strong research designs, many with random assignment. Little attrition was experienced in the follow-up study. However, one should be cautioned not to attribute the successes noted in this study to Head Start programs. First of all, these preschools had access to professional resources normally available only in university research projects and laboratory schools. In addition, teaching staff experienced intensive staff development and on-going support. Therefore, these programs do not demonstrate effectiveness of typical Head Start programs. However, results from this study are indicative of the benefits attainable from high quality, resource-intensive early intervention programs.

- **High/Scope Perry Preschool**

One of the Consortium participants was the High/Scope Parry Preschool in Ypsilanti, Michigan. The program began in the early 1960s and involved 123 African American preschoolers from low socioeconomic backgrounds. Teachers visited each child's home weekly, and a majority of the program attended the half-day program for two years. The researchers at High/Scope continued to follow program and control group children to age 19 and looked at a broad set of outcomes including teenage pregnancies, arrests, and unemployment.

The study found lasting benefits of preschool education in improving cognitive performance during early childhood; in improving scholastic achievement during the school years; in decreasing delinquency and crimes and increasing high school graduation rates and frequency of enrollment in postsecondary programs and employment (Berrueta-Clement, et. al. 1984; Weikart, 1989).

Like other Consortia studies, this project did not evaluate Head Start programs; therefore, at best, it is suggestive of possible outcomes of high-quality and resource-intensive early childhood education programs. On the other hand, this study has some design problems that have implications for the validity of the findings.

Many criticize this study for its small sample size: only 58 children were in the "treatment" group and 65 were in the control group. Small sample size limits one's ability to "slice" the data in many ways and still maintain enough variability between the treatment and control groups to be able to detect differences in outcomes. In addition, the evaluation design did not take into account the subsequent life events and environmental circumstances -- at home, school, or the community -- that are bound to affect the likelihood of school success, criminal activity, pregnancy, and welfare receipt.

CURRENT HEAD START RESEARCH

In 1989 and 1990 Head Start convened an Advisory Panel for the Head Start Evaluation Design Project for the purpose of recommending future directions for research on Head Start. It had been widely expected that the panel would recommend a large-scale, longitudinal study to examine the effectiveness of the program. This was not the panel's recommendation, however. Rather than a single big study, this expert group recommended a series of smaller efforts organized around two principal questions:

- Which Head Start practices maximize benefits for children and families with different characteristics under what types of circumstances?

- How are gains sustained for children and families after the Head Start experience?

The Panel's recommendations are contained in its report, Head Start Research and Evaluation: A Blueprint for the Future. A current panel is examining ways to implement the "Blueprint" report. In addition, three major efforts are currently underway to examine ways to increase the impact of Head Start and related programs for low income children. All have evaluations in progress.

- The Head Start/Public School Transition Demonstration is testing the hypothesis that continuing Head Start-like services into the schools will enable initial gains to be maintained. Currently 32 programs operate demonstration projects for a total funding level of $20 million per year.

- The Comprehensive Child Development Program begins services at birth and provides services over a several year period. This program is testing the hypothesis that reaching families earlier, and providing services over an extended period of time, will provide sustained benefits.

- The Family Service Center demonstrations are examining the effect of strengthening the social services component of Head Start. In an attempt to help families toward self-sufficiency, these programs address the problems of illiteracy, employability, and substance abuse.

CONCLUSIONS

Numerous studies have shown Head Start effective as a school readiness program. Head Start children begin school with improved self-esteem, social behavior, health, and achievement motivation. When thinking about research on Head Start, it is important to recognize that Head Start is a comprehensive program designed to benefit children and families in a variety of domains. To look only at children's cognitive achievement is to miss much of Head Start's strength. While a specific cost-benefit ratio has never been calculated for Head Start as has been done for the High/Scope Perry Preschool program, we do know

that the program has significant benefits for children and families. Reduced need for special education and an increase in children's ability to remain on grade level have been demonstrated.

No short-term program -- including Head Start -- can magically and permanently reverse the problems caused by poverty. Most children attend part-day, nine month programs. If indeed some of the cognitive gains "fade out" over time, it is not surprising given that these children still live in poverty with all that entails -- such as family stress, poor schools, unsafe neighborhoods, inadequate nutrition, and so forth. It is essential to remember that a solid preschool experience such as Head Start is important to poor children, but it is only one intervention that they need in their lives. Head Start cannot be expected to assure singlehandedly that children succeed in later life.

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Mr. ARCHER. I am curious as to how we can continue to hear $3 and $6 for one benefit cost with no basic research studies of Head Start on which to base that. That is misleading to the American people. Rather than dealing in emotion and ideas of people in an ivory tower, it seems to me this country would be well served by getting basic research on Head Start and then moving ahead. If it does produce the benefits relative to the cost, then we, by all means, should support it.

Mrs. KENNELLY. Would the gentleman yield?

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. Jacobs will inquire.

Mr. JACOBS. Secretary Shalala, I want to ask something very fast, and I just want a general attitude on your part because I want to get back to another thing after that.

During the 1980s, about 16,000 people were fired or let go over at Social Security who answered the telephones and looked into the applications for disability and so on. The backlog on disability makes you wait about, I think, 3½ months now before your application is even looked at. You can just let your arm dangle broken or whatever it is for 3½ months before they even look at it. How many people do you think we should add to the staff at Social Security to bring that down to a reasonable waiting period? Just a number, if you have it. If you don't, get it and submit it.

Secretary SHALALA. We will submit it for the record.

I think that we are suggesting 750 to address disability work loads, but Congressman Jacobs, I should point out that that will allow us to keep up. We are not suggesting by these new investments that we are actually going to get ahead of the game, though we do have some ideas about retraining and different decisionmaking that may, in fact, help us to begin to take a bite out of the load.

[The information follows:]

The increase in the backlog of initial disability determinations cannot be resolved overnight. SSA will do the best it can with the resources available.

In FY 1993 initial disability determinations are expected to reach 2.5 million, an increase of 13 percent over FY 1992 and a 46 percent increase over FY 1990. A further 12 percent in applications for disability benefits is projected for FY 1994.

SSA's goal in FY 1993 is to maintain the momentum established in FY 1992 in SSA and the Disability Determination Services (DDSs) in processing additional disability determinations. The Administration requested a $302 million supplemental appropriation in FY 1993, including $192 million to continue efforts to process disability applications and to keep initial disability claims backlogs at about 16 weeks. The supplemental appropriation request was not approved. Overall SSA workload backlogs will increase; however, SSA will use the funds available to continue the momentum built up for processing backlogged disability cases in SSA and the DDSs.

In order for SSA to maintain the current service levels projected for FY 1993 in the FY 1994 President's budget (e.g. reduce the projected initial disability determination pending workload in the DDSs from 1,320,000 to about 870,000 cases, or to about 16 weeks of work on hand at the end of September 1994), SSA would need to process an additional 450,000 initial disability determinations, as well as the reconsiderations, hearings and appeals which flow from the backlog to completion.

Last year, based on a general model, SSA indicated it would need about $100 million and 1,000 Federal workyears to process an additional 100,000 additional disability determinations, as well as the reconsiderations, hearings and appeals. More recent experience shows the cost to process 100,000 disability determinations is expected to be about 15 percent lower. Using the general model developed for the FY 1994 budget, SSA would need about $85 million and 900 Federal workyears to process an additional 100,000 initial disability determinations. Given current workload projections, SSA would need about $300 to $400 million and 3,000 to 4,000 Federal workyears to process 400,000 to 500,000 additional disability determinations as well

as the reconsiderations, hearings and appeals which flow from the backlog to completion in FY 1994.

Mr. JACOBS. Okay. Now, let's come back to cognitive preschool for educationally disadvantaged children.

I am sure you are familiar with the study made back in 1968, the Westinghouse study, which showed, which concluded—this wasn't in the headlines, but if anybody took the trouble to read it, it concluded that the trouble with Head Start was it was too little and too late. Yet there still was a significant statistical indication that it had an effect.

Some people would say as the twig is bent, so grows the tree, and I say to my friend whom I love dearly, from Texas, we don't need a lot of research on that. If you don't inculcate linguistics in our little tape recorder minds as we are in that malleable stage of life, then mush will come out. If we don't inculcate the general ideas of playing the game of the society in that early period of life, then that person probably will be—or quite often will be capable of doing violent crime and not have much compunction about it.

As far as I am concerned, the Defense Department, the Police Department, the Fire Department, everything we do in this country pales in significance with the one possibility we have to save ourselves physically from an ocean of ignorance which continues to grow in our country and explains why people don't learn to read when they go to school, because they never learned to say or to hear articulately.

Having said that, in 1988 we had a reform of welfare pass Congress, signed by President Reagan. In that reform there was a requirement that HHS conduct a pilot program in each of the 10 AFDC regions in which college students would be given college credit, academic credit, for helping in poor homes, ostensibly to help the single mom with little children, but at the same time inevitably inculcating these linguistics for the little children. College credit, no expense. College moves ahead because of the education that is given, the field training to the students and so on.

Then at age 3 and beyond, establishment of centers much like Head Start, I suppose, preschool where volunteers would be recruited, again not a lot of money, just tapping what is already there and available without a lot of money. Now that was 1988. It became law in 1988. It has not been done. It still has not been done in 1993.

My question to you is, do you think it is time we did it? Just the pilot programs?

Secretary SHALALA. Well, I think that the President's recommendations for expanding the Head Start program during the summer is consistent with that.

Mr. JACOBS. Does it involve college credit and volunteers? No. And it costs a lot of money. And does the other? No.

Secretary SHALALA. The point here is that the emphasis for those summer Head Start programs is placed on literacy development. In addition to that, we intend to use the National Service Corps in the summer program, hopefully working with some of our Head Start programs. And that, too, would fit in with at least the themes that you are suggesting.

Mr. JACOBS. This is volunteerism. It is the law. And the question—I am one of your admirers, too, but I am going to bore down on this one. The question is, do you intend to carry out the law with regard to those pilot projects that will cost practically nothing?

Secretary SHALALA. The answer is yes.

[Additional information follows:]

Section 501 of the Family Support Act (P.L. 100–485) authorized the Family Support Demonstration Projects at up to $6 million per year for fiscal years 1990 through 1992. Therefore, the statutory authority for the demonstrations described above has expired. If the Congress reauthorizes and appropriates funds for these projects, the Department of Health and Human Services will act expeditiously to implement them.

Mr. JACOBS. Thank you. I yield back the balance of my time.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Madam Secretary, we have been discussing cuts in Medicare, Medicaid programs as a whole. We have got a relatively new technology that is being used now called video medical care, where medical personnel originate a program from a certain clinic to another hospital, perhaps rural hospital or another place, and give instructions or a complete diagnosis of not only a case, but perhaps even an operation. It has worked well at Mayo Clinic and I think perhaps a few sites in Texas and other places. Medicare, HCFA, though, will not recognize it as an item for reimbursement.

Do you have plans under the new budget to consider them for reimbursement under this program?

Secretary SHALALA. We do not, but under your recommendation we are certainly happy to look at it.

Mr. PICKLE. Of course, that is very consoling. I ask you to look at it because I think proponents make a good case and they render a service. And if it is beneficial in doing a job and it frees up hospital beds, then it ought to be included as a regular reimbursable item. I think you ought to give serious consideration to it.

Secretary SHALALA. I would be happy to.

Mr. PICKLE. The second thing is, we have a program under practice now with respect to disproportionate share where there is reimbursement for the money under the Medicaid program, and States will match the Federal Government. It has been growing, and each State or many of the States have, quote, overused, if not abused, this privilege.

Now, the past administration tried to clear this thing up, and we gave them a little bit more time, thinking they would have a different formula. Do you have a specific plan for the disproportionate share consideration?

Secretary SHALALA. We do, under the President's direction, and we are in the midst of discussions with the National Governors Conference specifically on this issue and expect to come to some conclusion within the month.

Mr. PICKLE. I noticed a couple weeks ago the President met with the governors in which he, I would say, cut a little slack for them, gave them a little bit more time. I am going to presume that it will be just a little more time before you correct this situation. It is difficult for the States to carry out these Medicaid costs, so we don't

question that, and maybe under the new system we can do something about it.

But we are not much in a position today, from a Federal Government standpoint, to keep paying out these double matching funds because the costs under both Medicare and Medicaid have been going up and up and up, almost doubled, so I think you ought to have a specific plan.

So my question to you is if you are going to have a recommendation within 30 days, is that recommendation to try to cut those expenditures out?

Secretary SHALALA. I think I would describe the recommendation as one of attempting to get some mutual agreement so we can get some discipline in the system and some understanding of what is allowed and what is not allowed and some fairness among the States in terms of the taxes that are appropriate and those that are not. The system has just been wild, and the States recognize that, the Federal Government recognizes it. I am sorry for my unwillingness to be more specific, but it is, in fact, a thoughtful conversation that is going on with the National Governors Conference, and I do not want to preempt our ability to come to a consensus with them.

Mr. PICKLE. Well, my State, Texas, has entered into this matching increase. So has Arkansas and some of the big States, California and Florida, maybe Illinois. I don't know. They all have. While we can be sympathetic, it makes our problem only worse.

Lastly, Madam Secretary, I am concerned about the disability program. Social Security is terribly behind in making disability determinations. It is stacked up over a year, upwards of a million cases backed up. We can't get action on them. I can't get any full agreement from SSA about my own State and the building they are going to promise to build. They start forward, move back, start forward, move back. Now, what emphasis can you put on the disability program to start clearing that backlog up?

Secretary SHALALA. Congressman Pickle, it will be among our highest priorities. It is very clear that we cannot justify, no matter what the resource explanation is, taking months and in some cases years for people to get a clearance about their disability and the possibility of getting on the Federal program. We have asked you here for an investment in the program, and we intend to move with these new positions as well as with a new strategy to be able to shorten the time in which people get answers.

Mr. PICKLE. Madam Secretary, I ask you to put some heavy emphasis on it because we have been going to fix that for years. It has gotten worse and worse. If we don't do something in a drastic manner, we are all going to be terribly embarrassed. So I hope you give it top priority.

Secretary SHALALA. Thank you.

[Questions for the record for Secretary Shalala and her responses follow:]

Secretary Shalala
Question for the Record

Pickle (1)

Question:

It is my understanding that under the Administration's budget proposal the Department of Health and Human Services would have to reduce its staffing by about 5,000 people over the next four years.

In light of the increasing workload you have in the area of health care, what portion of this 5,000 person staff cut will have to be absorbed by the Social Security Administration?

Answer:

As indicated in the President's Fiscal Year 1994 budget request, overall Federal employment will be reduced by 100,000 Full-Time Equivalents (FTEs), or 4 percent, from the FY 1993 base to the FY 1995 FTE estimates.

During this period, Federal employment in the Department of Health and Human Services is to be reduced by 5,200 FTEs, a 4 percent reduction, from a FY 1993 base of 130,000 FTEs to 124,800 FTEs for FY 1995. At the same time, it is projected that Federal employment for the Social Security Administration will be reduced by about 1,550 FTEs, a 2.4 percent reduction, from a FY 1993 base of 65,409 FTEs to 63,855 FTEs for FY 1995.

Pickle (2)

Question:

The Disability Insurance program under SSA has experienced increasing difficulties over the past several years. The initial claims backlog is now up to 700,000 claims and it is estimated that this backlog will increase to 1.1 million by the end of this fiscal year. Claimants now must wait for months to have their cases decided. In addition, SSA has almost stopped conducting Continuing Disability Reviews (CDRs) to make sure that people do not receive benefits when they are no longer disabled. There is a current backlog of 1.1 million CDR cases which, if worked, would save the government about $1.4 billion according to the General Accounting Office (GAO). The GAO estimates that we save $4 for each additional $1 we spend on CDRs. It seems to me that we could almost pay for reducing the initial backlogs with CDR savings.

What plans does the Department of Health and Human Services have to reduce the initial claims backlogs, and to step up the CDR process?

Answer:

As you know, the backlog of disability claims is one of SSA's most critical problems. Despite all the management improvements an innovative techniques that we have employed to deal with the disability workloads, the workload increase has been so large that our resources have been severely strained.

In FY 1993 initial disability applications are expected to reach 2.5 million, an increase of 13 percent over FY 1992 and a 46 percent increase over FY 1990. SSA's goal in FY 1993 is to maintain the momentum established in FY 1992 and the first half of FY 1993 in SSA and the Disability Determination Services (DDS) to process additional disability determinations.

Thus, we planned to use about $200 million of the $302 million FY 1993 supplemental appropriation to continue efforts to keep disability claims work on hand at about 16 weeks and to begin addressing the backlogs in the Office of Hearings and Appeals. Without the additional funding from the supplemental appropriation, the backlogs will increase and people could wait another 2 to 3 weeks for their disability determinations to be processed.

With respect to the CDR process, SSA is keenly aware of the importance of conducting CDRs and is very concerned that we have had to limit the number of CDRs due to the unprecedented growth in the disability initial claims workload. We plan to implement a new CDR process nationwide soon which we believe will enable us to make the most efficient use of our administrative resources and be least disruptive to disabled beneficiaries.

SSA briefed the Ways and Means Social Security Subcommittee staff on the new CDR process on April 7, 1993.

Pickle (3)

Question:

It is estimated that DI Trust Fund could become insolvent as early as 1997. When do you think the Administration will request either higher FICA taxes or a reallocation of assets currently going into the OASI Trust Fund to maintain the solvency of the DI Trust Fund?

Answer:

In its 1993 Report, released on April 6, 1993, the Board of Trustees of the OASI and DI Trust Funds estimate that the DI Fund will be exhausted in late 1995 under the intermediate set of economic and demographic assumptions. The Board has recommended to the Congress that the Social Security payroll tax rate be reallocated to address the immediate financial needs of the DI Trust Fund.

The Administration recommends legislation to reallocate 0.275 percent of the Social Security tax rate from the OASI Trust Fund to the DI Trust Fund, beginning with 1993. Under this proposal, the OASI rate would become 5.325 percent, and the DI rate would become 0.875 percent each for employees and employers. (The rates would become 10.65 percent and 1.75 percent, respectively, for the self-employed.)

The proposed reallocation would result in short-term financial soundness of the DI Trust Fund, without endangering the OASI Trust Fund in the short range. Under the proposed reallocation, the DI Trust Fund would not be exhausted until 2020.

Such a reallocation would provide the necessary time to study the DI program and develop initiatives to address the long-term financial status of the DI program.

Mr. PICKLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Thomas will inquire.

Mr. THOMAS. Thank you, Mr. Chairman. I ask unanimous consent that my written statement be placed in the record.

Chairman ROSTENKOWSKI. Without objection, so ordered.

[The statement of Mr. Thomas follows:]

STATEMENT OF THE HON. BILL THOMAS
Committee Ways and Means
March 10, 1993

MR. CHAIRMAN, I am pleased to have Secretary Shalala here with us today. I am sure we will all benefit from today's dialogue.

The main question I would like answered during today's hearing is how the Secretary expects the Medicare and Medicaid cuts proposed in the President's budget to fit into efforts to reform our health care system. Several reports have shown that past cuts in Medicare provider reimbursement rates have caused a shifting of costs to private payers. The President's budget recommends further reductions in reimbursement rates and I am concerned that this will hinder our efforts to control private health care costs.

Also, I am hopeful that the Secretary will shed some light on the place federal health care programs, such as Medicare and Medicaid, will have in the reformed health care system currently being devised by the White House. In specific, will they continue to be separate structures, or will they be conformed to the insurance available to other Americans? Will they be expanded? Before we discuss changes in the Medicare program, I believe we should consider the future of the program. In fact, I am not sure whether it is wise, at this time, to recommend any changes in the Medicare program because we do not have a clear idea of how it will interact in an improved health care system.

Finally, I would appreciate the Secretary telling this Committee how the Medicare cuts proposed by the President are expected affect the availability of care to Medicare recipients. Has the Health Care Financing Administration completed any studies on the effect past reimbursement rate reductions -- for doctors, hospitals, outpatient facilities, labs, and other providers -- have had on the availability of health care to the nation's elderly? I have received several letters from Medicare recipients in my district whose physician has stopped being a participating physician because of the cuts in Medicare reimbursement. Is this a growing trend across the United States, or in certain segments of the United States? How will the proposals made by President Clinton in his budget affect the current situation?

Again, I would like to thank the Chairman for inviting Secretary Shalala, and thank the Secretary for agreeing to meet with us and give us more details about the President's plans. I look forward to our discussions today.

Mr. THOMAS. Madam Secretary, I want to compliment you on your learning curve. I have watched you go through three Members, and if you continue that there won't be a need to come back by the end of today. Look forward to a return visit.

On pages 4 and 5, you indicated that the President was going to deal with deficit reduction to the Social Security Administration in two ways: One, the increase in the tax on those people who are already paying a portion, they will pay more; but, secondly, you were going to assess the States a head fee, I guess, for administering SSI programs.

You have a two-part rationale. One, because States are different, that makes the administration of the program more complex, but then I guess you have a second argument saying even if they were all the same we should charge them anyway.

My question goes along these lines: In the budget, the President says he wants to make government programs work by shifting from a top-down bureaucracy to entrepreneurial government that generates changes from the bottom up. Now, I understand, I guess, if the Federal Government is going to administer Social Security they can ding the States for the part they are participating in and try to deny any creativity or structural differences that the States think are important for uniformity.

But we have got a lot of programs in HHS. Just pick one subject, the poor, tens upon tens of programs. Is there any discussion going on about what role the States are going to play? Are they going to be creative agents? Are we going to be able to combine some of these very specific programs, and if we don't go to block grants per se, are we going to provide some ability for States to be a creative part of the process?

I guess it would extend eventually to health care as well, but we will hold that part off until you get more specific on that. Just general programs that exist now, how are you implementing the President's stated position of desiring to have entrepreneurial government bubble from the ground up rather than a top-heavy bureaucracy dictating down? And how does that coincide with what you said about SSI and State structures?

Secretary SHALALA. Well, I think that the decision on SSI, which is sharing the costs with the States for the administration of the State portion of the SSI, is consistent with that, and that anything that we do in terms of reforming government has to be a partnership with State government. We have to think more clearly about the role of the States within the Federal system, about what programs they ought to administer, where the incentives ought to be for them to streamline their own processes, and where the incentives ought to be for us to do the same. But you cannot do one piece without doing the other.

What we have learned from monkeying with the Federal system is that if we push down this part, it pops up over here. And I think that is why it has to be very much a creative partnership between us and the States. Certainly in the areas of reforming health care and welfare, there is not a possibility of getting a different culture and a different philosophy unless the States are very much the partners. And, as you well know, we have gone through a decade of the States very much being again, as they were in the 1930s, in-

novative in terms of social reform and ideas which are being tested, and I think that we have to continue on that route.

Mr. THOMAS. I guess this is one statement that is specific which goes to the bureaucratic uniformity on a top-down basis, whether of necessity or desire. Where is there in your testimony any indication of movement toward the bottom-up entrepreneurial government comment that the President mentioned was to be his goal?

Secretary SHALALA. I am sorry, I could have answered that more directly. We at HHS very much intend to use the principles of total quality management, both in identifying our customers, clearly making sure that we get their feedback, making sure that they are very much part of a continuous improvement process.

In our need to change the top-down philosophy of these big public agencies, we have to try a very different approach in terms of empowering both the people who work in the agencies as well as our relationship with the States, with local governments, and with other participants.

Mr. THOMAS. I guess my first example of changes that are going to be made is a top-down bureaucratic suggestion, it is going to bulge out somewhere else. I look forward to examples as you generate them of showing us that President Clinton's statement about a bubbling up from the bottom entrepreneurial government working relationship will be evidenced by a coordination, restructuring and changing of programs inside HHS. I look forward to some specific examples of the President's statement in action.

Thank you very much.

Secretary SHALALA. Fair enough, Mr. Thomas.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

Secretary Shalala, I would like to thank you very much for all the help you have been giving those of us on the Ways and Means Committee, and certainly we look forward to working with you. We think you are going to be truly one of the great secretaries, and we look forward to watching you to change the direction not only of the Department but of the country as well. I want to congratulate the President for his selection.

Secretary SHALALA. Thank you very much, Congressman.

Mr. MATSUI. I would like to just comment very briefly on the Head Start program. And this doesn't require a response from you. Even though there may not have been any definitive studies on Head Start itself, all the studies that were mentioned indicate either a 7 to 1 or 6 to 1 savings on programs that are set up. And it is somewhat unfortunate that over the last 12 years, during the last two administrations, for some reason HHS never did think of doing a study on Head Start. And perhaps they didn't want the data because it would have shown that Head Start was beneficial to children.

So I am sure that we are going to be getting some studies out of this administration because I think that whatever comes out will be supportive of continuing and expanding the Head Start program.

There is another thing, too, that I think Members of the other side of the aisle should be aware of. If, in fact, we want to get people off welfare within 2 years and provide education, job opportuni-

ties and jobs for these people, they are still going to have young children. And I suppose we can just let the young children be latchkey kids and do nothing, but the key is that Head Start will provide two purposes, not only enriching that child for the future but also providing day care and educational opportunities while the mother is engaged in work and education and other pursuits that we want under the welfare reform package. And so it really fits in. It is a holistic approach that even the conservatives agree with in terms of how we deal with making sure children actually reach their full potential.

What I really would like to ask you, however, is in the area of financing welfare reform. We know that if we do want to expand and provide access to the 37 million people that don't have access, there must be a way to fund it. The President has talked about excise taxes, perhaps on alcohol and certainly on tobacco, and others have suggested that as well. There will be a consensus because there will be benefits along with, obviously, additional taxes, so there will be a constituency to raise taxes to pay for this program presumably. But in the area of welfare—and, of course, we spoke with Mr. Panetta yesterday—we need to seriously examine how we will fund these reforms.

In addition to the time limits, we also have the need to develop an infrastructure, and there is no question there will be attendant short-term costs involved in all this. I am not asking you specifically for any solution in this hearing, but it is my hope that, once the inner-departmental process begins, that a funding mechanism be thought of at the same time, one that will be acceptable to all of us. Because, undoubtedly, it is going to be very difficult to convince suburban constituencies of ours that we should provide revenues in order to provide job opportunities or educational opportunities for people that are on welfare.

I know it is going to be very difficult, but I think it appears that we all want to move ahead on some kind of welfare reform package with a strong child support enforcement provision in there, so we will need additional revenues. And even, I believe, members of our subcommittee on the other side of the aisle, Mr. Santorum and Mr. Shaw, they came in with a package that does have about $3.5 billion worth of additional spending, although they don't identify the source of where that spending is going to come from.

So perhaps, over a period of time, we will be able to develop that. I would just make that observation.

Secretary SHALALA. I am sure we will be able to work together on that issue. The President is committed to putting that package together, and we look forward to working with your subcommittee.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Welcome.

Secretary SHALALA. Thank you, Mr. Levin.

Mr. LEVIN. We so look forward to your leadership. We had some testimony on Monday on the issue of fraud and abuse in the medicare system. Mr. Stark and I introduced a bill, H.R. 1255, on Tuesday. We will look forward to working with you on this.

It is a major problem, but not so easy, and I think it is going to take real collaboration. It is a way that we can save money not perhaps easily but painlessly except for those who deserve to suffer the pain, those who defraud. So we will look forward to working with those you assign to this.

Let me mention another area which isn't so painless. It relates to your testimony on page three, and the Chairman asked you about the impact on inner city hospitals. It is really not only inner city but some suburban hospitals that also bear the brunt of a lot of the uncompensated care. You know, we worked with the previous administration on proposed cuts. We worked hard to try to make sure that the cuts impacted sensitively so that those most in need were not hurt the most. And I want to just raise this flag. I haven't had the time to fully examine the data that has been submitted to us. It affects the impact of this, the effort to redirect the subsidies so that they favor training for primary care. A number of us, Mr. Cardin and others and I, have worked on this. It is not so easily done but has to be.

But I am also worried about the way the proposed cuts would impact. According to information we have received, almost 50 percent of the reduction, not in indirect but in GME, would be on hospitals in New York City. I raise it because I don't think we should be concerned only about the system as it affects our own particular States because in the end, if it isn't fair, eventually our States will be hurt, and that would be true of inner city and suburban hospitals in Michigan perhaps.

But when you change to a national per-resident amount, instead of the present system without reflection of regional cost differentials, there is the potential for a particularly heavy impact in areas that are heavily impacted by uncompensated care. And I am not sure that you want to comment on this now, but I want to flag that our health subcommittee and the entire committee has really been striving to make sure that cuts and formulae are fair across the board.

Mr. Rostenkowski led an effort a couple years ago to put nonlabor cost differentials into the formulae because they are real costs. And I am worried that, as we make these cuts—and we are going to have to do it—that there may be an unfair impact.

Secretary SHALALA. The policy, Congressman, is still under development. I am not surprised at the impact of the slowing down of the increases on New York City because of the number of specialists that are trained there. I would like to point out, though, that New York has a shortage of primary care physicians, and so any effort to shift incentives to primary care physicians, of course, would help large cities that need more primary care, and I think we need to look at this very sensitively.

I, obviously, come from a great university that has a large teaching hospital, so I have a personal concern as we move through this, but the differentials are still huge in terms of the teaching hospitals, the contributions we are making to them versus other kinds of hospitals. Whether we have hit them too hard or not, I think we ought to have that discussion. I think that we tried to be sensitive as we looked at this. We used the data from ProPAC and went way under their actual recommendation as we did this slowing down of

the increase. We would be happy to both have a discussion with the committee—with the subcommittee in particular—about our underlying philosophy which was making sure we continued our support of primary care.

Mr. LEVIN. Thank you.

Chairman ROSTENKOWSKI. Mr. Shaw will inquire.

Mr. SHAW. Thank you, Mr. Chairman.

Secretary Shalala, I appreciate this early opportunity to get acquainted with you over the podiums here and question you a little bit about the welfare reform of the President and your interest in it.

Mr. Matsui brought up H.R. 741, which is a bill that has been filed by many of us on the Republican side, which, interestingly enough, is almost identical to a bill that we filed over a year ago, and also seems to have been mirrored by the President this last summer in changing welfare as we know it today.

In your statement you make four points. The third point is the one I would like to focus your attention on. That is page five where you state that providing people who can work with the training and support they need to move off of welfare. The President's proposal and the Republican bill contain time limited AFDC—they both limit AFDC to 2 years—at the end of which time work is an absolute requirement. Do you support that?

Secretary SHALALA. Congressman, I think what I would like to say here is that I am not in a position today to support any specific piece of legislation that is being recommended, but we do intend to take into account that particular bill as we put together the welfare reform package, and you can be assured that we will take it very seriously. There are, obviously, some streams of thought that come together in terms of ideas about welfare reform, and there are some other pieces that need to be added to it.

I have read the bill. We will take it seriously and consult with the committee as we work through the welfare reform bill.

Mr. SHAW. I very much appreciate that.

When the President was up here the other day speaking to some of the Republicans, including the Republicans on this committee, he again stated that he intended to time limit AFDC. Now, without reference to my bill, I am going to squeeze you a little bit. Will you support the proposition of allowing people a lifetime window of 2 years on AFDC and then at the end of which to require work if the benefits are to continue? Keep in mind that training and job search would be in effect during the 2 years and would continue in effect.

Secretary SHALALA. As part of the overall welfare reform package, the President has made very clear that we need to have a strong time limit and to make the program truly transitional. And he certainly has said 2 years, as I have said, as the goal that we are aiming for. I want to repeat that this has to be part of a whole package of support systems in our effort. It includes child support enforcement as part of that package, a very strong element. It includes jobs and job training. It includes the expansion of Head Start and child care as part of the overall package.

Mr. SHAW. But with these additions you will support time limiting AFDC?

Secretary SHALALA. With these additions, we intend to have within a program very firm time constraints on the program.

Mr. SHAW. I guess that is as close as I am going to get to yes or no.

There are also laws right now on the books that restrict States' ability to require work for AFDC recipients, restricting the kinds of work that can be performed, the hours of work that can be required, and the number of months that recipients can be required to work. The average State is only allowed to require about 21 hours of work a week. In one State, the maximum that could be required is about 6.5 hours per week.

Now when we start talking about work, I think it is necessary for us to talk about, one, are we restricting the type of work that can be required? And, two, are we requiring that these people can only be required to work a very limited number of hours, rather than as people in the real world, who are out there required to work 35 or 40 hours a week?

Would you support the repeal of some of these laws that restrict the intention that the President has stated, as interpreted by the American people, that these people will be required to have a job in order to continue to receive their AFDC payments?

Secretary SHALALA. Congressman, we will support a proposal that has real work for real periods of time as part of our overall proposal. It is not going to be a sham.

Mr. SHAW. Good. Well, I am quite satisfied with that answer. Thank you. We look forward to working with you.

And just one short comment. The President also said that he would include Republicans on the drafting of that legislation. I would hope and welcome the opportunity for my colleagues and I to be involved in the drafting of the legislation which is going to require, I think, a bipartisan support for passage.

Secretary SHALALA. We look forward to working with you.

Mr. SHAW. Thank you.

Chairman ROSTENKOWSKI. Mr. Cardin will inquire.

Mr. CARDIN. Secretary Shalala, it is a pleasure to have you here. We thank you very much for your leadership on health care issues.

I also want to express my appreciation and the appreciation of the employees of the Social Security Administration for your visit there to see firsthand the problems that we have in handling the disability determination cases. And I want to echo the comments of Mr. Jacobs and Mr. Pickle on the need to have adequate personnel and adequate facilities to handle disability determinations. We don't have that today, and it is not fair to the people who depend upon a timely consideration of disability determinations in order to be able to support themselves, so I urge you to please give that a very high priority as you make some of your initial decisions on staffing.

I also am very pleased about your statement in which you repeat what the President has said on the need for health care reform and health care cost containment as part of our economic strategy if we are going to be successful. Every other industrial nation has been able to get health care costs down to a growth rate approximately equal to its economic growth but the United States. Are you aware of any other system other than a single payer system or an all

payer system that has been successful in keeping costs down to approximately the growth of our economy?

Secretary SHALALA. No, but that does not mean we ought not to try.

Mr. CARDIN. Well, and I agree. I strongly support a system that will let us look for innovative ways to keep costs under control.

I am going to follow up on Mr. Thomas's point where he was asking on the welfare. I would like to ask on health care. Maryland, as you know, does have an all-payer system, and we have been successful in keeping costs below the national average. One of our major concerns is what happens as we develop national health care reform and establish national parameters on what type of benefits all Americans should be entitled to and how we provide for universal access, which we all—at least I support. I want to make sure that we let States have the flexibility to be able to continue proven cost-containment plans that they currently have under this new system. And I welcome your comments as to the ability of States to be able to use these types of proven successful cost-containment measures.

Secretary SHALALA. Congressman, all of our discussions thus far in health care reform have been to try to find a way in which we can improve the ability of States to try different kinds of approaches. It is tricky because, obviously, we need a national strategy with State flexibility inside of it.

I am well aware of the Maryland experiment and some of the real successes of Maryland, and I think it would be a shame if we tried to substitute for what we have already learned. So you can be assured that we are thinking about a system that includes taking advantage of what the State of Maryland and other individual States have already done.

Mr. CARDIN. I thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Brewster will inquire.

Mr. BREWSTER. Thank you, Mr. Chairman.

Madam Secretary, I certainly enjoyed your presentation. I think you have done quite an excellent job, put a lot of thought into this.

There are some questions that I do have on welfare. What part of that is nonmedical cost, what percentage?

Secretary SHALALA. What percentage of current welfare expenditures are nonmedical costs? I would have to get you that number. I am happy to provide it for the record. Welfare recipients are eligible for the Medicaid program, so I would have to sort out the numbers for you.

Mr. BREWSTER. Yes, ma'am, I understand that.

What percentage of medicaid, then, would be senior citizens in nursing homes or ambulatory——

Secretary SHALALA. Oh, I see what you are—what we need to do is to lay out the participants in the Medicaid program and tell you specifically who are the participants in the Medicaid program to give you some sense of what the impact of the reform would be. We would be happy to provide that for the record.

[The information follows:]

RESPONSE TO REPRESENTATIVE BREWSTER'S QUESTION CONCERNING THE SPECIFIC PARTICIPANTS IN THE MEDICAID PROGRAM

Estimates indicate that in FY 1992, over 30 million people were receiving Medicaid. A breakdown of Medicaid recipients by eligibility group follows:

Aged 65 and over	3,611,000
Blind and disabled	4,364,000
AFDC adults	7,435,000
AFDC children	14,427,000
Other title XIX	939,000
Total	30,776,000

Mr. BREWSTER. I know who are the participants in it, but I was curious what percentage it made up of the total cost.

And as we talk about health care, regardless of what we do in welfare reform, if we don't do something to stop the increasing cost in health care, we still have serious problems, and that is——

Secretary SHALALA. Well, that is correct. The relationship between health care reform and welfare, though, is also important because there are clearly large numbers of people who stay on welfare because they do not have medical benefits. The system currently provides an incentive in the wrong direction in my judgment. There are 37 million Americans and their families who go to work every day but do not have medical coverage, and yet if they chose to go on welfare to get their families covered, they would get a medical plan under a Medicaid program. So clearly there is a close relationship between what we are trying to do in health care reform and the impact on some of the families on welfare that are heads of household.

Mr. BREWSTER. Absolutely. I think probably the larger part of the whole welfare cost will be on health care—or a very large part of it will be—and that is the question I was asking.

Another thing is, we cut back on medicare. If we did cost containment in what you are talking about here, in essence, just cutting back on payments, will that not result in a cost shift to the private sector?

Secretary SHALALA. Only if the hospitals and the other providers are prepared to pass it on, and if someone is willing to pay the bill at the other end in the private sector. If there is cost efficiencies, if people tighten up and manage better, it can slow down some of that cost shifting. But certainly, up until now, we have seen a considerable amount of cost shifting, but that has been only because there has been a willingness on the private side to absorb those costs and an unwillingness to do everything in terms of management changes. It is clearly a management decision to cost shift.

Mr. BREWSTER. But I am told by numerous hospital administrators that the medicare reimbursement frequently doesn't cover the cost of the procedure and they have to cost shift. Is that correct?

Secretary SHALALA. No, it is not. The decision to cost shift is an internal management decision of an institution. They obviously have pressures within the institution to raise certain kinds of costs, and if they have someone down the line that is willing to pick it up, obviously, that will relieve their pressure.

Mr. BREWSTER. So medicare reimbursement fully covers all costs?

Secretary SHALALA. No, it does not, and I did not suggest that. It is based on a percentage of costs and it has been over the years,

but that does not mean that those costs have to be shifted, only that it is based on past history in terms of what the costs are. It is a management decision to pass those on to the private sector, and we have been able to do that because the private providers, the private insurance companies, were prepared to pick it up.

Mr. BREWSTER. OK. Let me look at it another way, then. As an administrator, then, if Medicare reimbursement doesn't cover the costs, how do you operate your hospital unless you do shift it?

Secretary SHALALA. Well Congressman, I did manage a university in which I was not able to shift everything onto tuition. I had to make internal cuts and downsize and make all sorts of changes. I simply do not accept on face value that one automatically has to pass on the costs to another set of recipients. It is a management decision.

I will concede that many hospitals are extremely well managed. They would argue that they have already cut to the bone. From my own experience of managing large institutions, it is hard to say that you absolutely have cut to the bone, so I think that this is—what I am suggesting to you is that, as a manager of large institutions, I do not accept on face value that one automatically cost shifts.

Mr. BREWSTER. I would agree with you on large institutions, especially teaching institutions, but many of our rural hospitals are not in the same posture as large institutions. Having been involved in health care most of my life, I have some understanding of that also.

Secretary SHALALA. Congressman, I do agree with that.

One of the things we have tried to do is protect rural hospitals and smaller institutions in the kinds of cuts we have made to try to reduce the possibility of cost shifting, and I think that, as we have gone through these contributions to deficit reduction, we have tried very hard to be very protective of rural institutions in particular because we do, indeed, agree.

I am sorry that I misunderstood you in terms of my response, but we did try to be more sensitive to rural institutions and do understand the difference between small and large institutions.

Mr. BREWSTER. Thank you.

Chairman ROSTENKOWSKI. Mrs. Johnson will inquire.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Welcome, Secretary Shalala. I appreciate the very eloquent statement of health care and welfare reform goals that you made in your testimony and support your comments 100 percent. I look forward to working with you to achieve those goals.

I want to make a couple of short comments and then ask two kind of yes or no questions.

First of all, I was disappointed to see that all of the savings that you cite in your testimony are really cost shiftings, either to seniors and to their tax base or onto States for administrative costs. Now, I realize, of course, you haven't been Secretary very long, but I hope when we gather a year from now that you will have had a chance to look at the 70 separate programs, most of which are under your jurisdiction, which address themselves to the needs of America's poor, and particularly America's urban poor. I think there is an enormous opportunity at this point to look at how we

can integrate those programs, eliminate some of the micromanaging, that has characterized our approach to helping people in the past.

My second point is in regard to the Head Start issue. In fact, Congress authorized the study of Head Start in 1981, but we never funded it. I think part of the reason that that happened is because there are a lot of Head Start variants out there that give us very good information about why Head Start works, but they didn't copy the Head Start models precisely because Head Start is so prescriptive. It is very expensive. So I think it is a perfect example of both the good and the bad of Federal leadership in these areas, and it is unfortunate that we never funded that study.

I have been very much involved in foster care reform, and I would just point out to you, because I imagine you haven't gotten into this yet, that the Federal Government has a capped grant that gives States money to try to strengthen families. We have an uncapped entitlement that gives States money to place children out of their homes. That is ludicrous. I have tried for years to reform it, and I hope that that is something that we can actually achieve in this next year.

I would very much appreciate it, if your schedule ever allows the opportunity, to walk you through how I prepared my bill because I think my approach had some creative aspects to it. That is my first question, if I could possibly have that opportunity?

Secretary SHALALA. We would be happy to come by and talk to you about the foster care system and the way the incentives run on our social services programs in general.

Let me say, on the Head Start program, in particular, that we accept the criticisms of the Head Start program, that we do not intend to take this money and pour it into an existing program that is not going to go through substantial changes. We do intend to invest these resources in better facilities, better training, and a higher-quality program. We believe in the Department and in the administration that it would be a mistake to strain and expand the existing program without substantial quality improvements over the next few years.

Second, let me respond to your point about cuts. We did not just take cuts out of the Medicare or Medicaid programs. In fact, the Department itself is going to substantially downsize and consolidate programs. We will lose 4,000 or so employees at the same time we are taking on major new responsibilities. We do intend to use modern management techniques, including total quality management, to try to increase both our responsiveness as well as the quality of our programs.

But more than that, what the Department intends to do is to go through systemic reviews, as we already are in health care reform as well as welfare reform, so that it will be a very different place in 4 years.

Mrs. JOHNSON. Thank you. I look forward to following that work. I think that is exactly what the Federal Government needs to be doing, and I am glad you had a chance to enlarge on your approach to savings with those comments.

Then, lastly, I just want to comment—on page 2, you say that you are going to try to keep the annual cuts in medicare at about

2 percent. I just wanted to point out that we did that. We reduced the rate of growth in medicare, on average, every year in the 1980s about 2 percent, and we took it, as do you, out of providers' reimbursements, not out of beneficiaries.

However, since what is driving costs in medicare is, in fact, the dramatic growth in demand, both by virtue of increased number of seniors and longevity and intensity of care and diagnostic capability, since it is volume that is driving cost, I believe there is a limit to how long we can micromanage reimbursements and not affect access.

I do disagree with my colleague, Mr. Cardin, in his statement that price controls have worked across the board. I would maintain they haven't worked. I would just call to your attention that in Connecticut we have had a clear reduction in access as a result of the volume adjuster and the RBRVS decision of last year. So I look forward to working with you on those.

Thank you.

Chairman ROSTENKOWSKI. Mr. Reynolds will inquire.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Thank you so much for coming today. Nice to see you. Congratulations on joining the administration.

Secretary SHALALA. Thank you.

Mr. REYNOLDS. The Chairman mentioned earlier some of the costs of inner city hospitals. I am going to bring this up to you. I brought it up to Mr. Panetta and to Mr. Bentsen. In Chicago, on the south side of Chicago, we don't have—for adult trauma, we don't have one hospital that is currently servicing anyone who has that problem. They have all closed down their trauma units for adults, saying they can no longer afford to have these operating on the south side of Chicago because of uninsured patients, in particular, uninsured gunshot victims.

We are concerned on the south side not having this kind of help. It has been editorialized in the Washington Post, in the Charlotte Observer, talked about yesterday in the Boston Globe, about an excise tax on guns to help pay for uninsured gunshot victims. Have you heard anything about this, the bill, that I——

Secretary SHALALA. No, I actually have not, Congressman. I would say, though, that on the south side of Chicago, on the east side of Cleveland, in the Watts area of Los Angeles, the lack of health care in this country for inner city residents, particularly in areas where there is a high level of violence, is in my judgment a scandal. And we have run the incentives in this country in a way that put our resources not there but in other places.

And until we are prepared to make a commitment to primary care, to health care for all Americans, until we are prepared to put together a major health care reform plan that puts its emphasis not only on primary care but on prevention and providing access to everyone, no matter what their income is, we simply are not going to deal with what is a systemic and structural problem in our system.

Mr. REYNOLDS. I would close just by saying that I agree it is, in fact, a scandal. Forty people are shot every single day in Chicago and two die every day in Chicago as a result of gunshot wounds. I would hope that you would consider this in the Health Care Task

Force as one way of adding to the dollars of helping to pay for health care in this country.

Thank you.

Mr. ANDREWS [presiding]. Mr. Santorum.

Mr. SANTORUM. Thank you, Mr. Chairman.

I am the Ranking Member on the Human Resources Committee.

You mention in your testimony that we need to do health care first and then we can do welfare reform. My understanding is that the administration's proposal on health care is due some time in May. I would take issue with that only in the sense that the President, when he spoke before the Republicans the other day, said that it would be only a matter of weeks before he would have his welfare proposal finished. He only said welfare reform was an excellent attempt to be bipartisan, that there were many things in his proposal that were in the Republican proposal, and that we could get to work on this right away. What is your comment on that?

Secretary SHALALA. We are at work on it, Congressman. I am just not sure that we will have it done on the first week in May, which is when the health care piece is coming. I am not suggesting that it is going to be years behind that, but we did start the health care piece first.

But, with no disagreement with you about the need for this administration to have a front-end welfare reform proposal, we simply did not put a 100-day limit on it and say we are going to have it the first week in May. But you can be assured that we already have senior staff and some very distinguished people working on the proposal.

Mr. SANTORUM. I want to follow up again on Mr. Shaw's question.

Number one the time-limited aspect of it. Number two—and I think the most important aspect of it—which is the work component. I have been trying to do a lot of study on welfare reform proposals, and the one thing that seems to me that works is some work requirement. That is the most successful aspect of getting people off welfare.

I think I understood your answer, but why don't we try it one more time? Are you supportive of a mandatory work requirement as a condition for receiving welfare benefits?

Secretary SHALALA. Actually, I would put it differently.

Mr. SANTORUM. I know. That is why I asked the question. I would like a yes or no answer to this question.

Secretary SHALALA. What we are going to do is to try to reduce the number of people who ever get on welfare by making sure that they go to work. That is number one.

Number two is——

Mr. SANTORUM. That is a good idea.

Secretary SHALALA. The President and I have clearly stated that we intend to make work the centerpiece of our effort to reform the welfare system and that this will mean a work requirement. But it is not a question of a work requirement to go along with welfare. It is a work requirement to substitute for the current welfare system. He is talking about changing welfare.

Mr. SANTORUM. Wait. Let's explore this a little bit. We have got to vote. Are you suggesting, then, that it would not be a condition of welfare that, if your benefits expired, that you would not have to work to receive your benefits, that that would not be part of your program?

Secretary SHALALA. We intend to substitute, as the President has already recommended, something for welfare benefits. In this case, the President has recommended an Earned Income Tax Credit.

Mr. SANTORUM. That is separate. That is if you are out working that you wiil get support for doing that work.

I am talking about people who are on welfare whose benefits have expired. Because you told Mr. Shaw that you support this being a transition program in the sense that we are going to have time-limited welfare.

Secretary SHALALA. The answer to the question is that everybody who can work, who is not on a disability program, must go to work.

Mr. SANTORUM. Okay. So you do support everybody who can work——

Secretary SHALALA. Absolutely. That is what the President said. That is what I have said consistently.

Mr. SANTORUM. You said that consistently.

This is the first time that I have ever had this opportunity, to actually have more time than I can use, but I have to go vote. I do have some questions that I would like unanimous consent to submit in the record at this point——

Mr. ANDREWS. With no objection.

Mr. SANTORUM [continuing]. And get answers from you. Thank you.

[The information follows:]

RICK SANTORUM
18TH DISTRICT PENNSYLVANIA

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March 11, 1993

The Honorable Donna Shalala
Secretary
U.S. Department of Health and Human Services
200 Independence Avenue S.W.
Washington, D.C. 20201

Dear Secretary Shalala:

I want to thank you for your testimony before the Ways & Means Committee today.

The time constraint of the question and answer period prevented my discussing with you the Head Start program as well as several health care reform options. As part of the hearing record, I want to pose a few follow-up questions regarding Head Start, medical savings accounts, as well as several proposals pioneered by Blue Cross of Western Pennsylvania.

As the Ranking Member on the Human Resources Subcommittee, I want to follow Mr. Archer's interest in and questioning on Head Start. Specifically and for the record, I would like for you to provide complete references to all studies of Head Start children that produce benefit cost figures.

With regard to health care reform, I want to discuss with you the concept of medical savings accounts. Last year, I introduced legislation, H.R. 4130, establishing individual medical savings accounts as a health care option. In planning for the reintroduction of the legislation, I am interested in your comments on the proposal and the potential inclusion of medisave accounts in the Administration's proposals. I have enclosed some briefing materials for your review.

Last, I want to focus on health reform policies. Specifically:

(1) Is the President's Task Force on Health Care Reform focusing on innovative programs of coverage successfully offered through the private sector?

(2) Has consideration been given to a program pioneered by Blue Cross of Western Pennsylvania known as The Caring Program for Children? The Western Pennsylvania Caring Foundation has received grant funding from your department's Maternal and Child Health Division.

(3) Will consideration be given to programs such as the Special Care Program in Pennsylvania? The program was developed by the state's Blue Cross and Blue Shield Plans and offers access to a standard benefit program available to individuals for as little as $2 a day.

I appreciate your time and attention to this request and thank you again for your testimony today. I look forward to hearing from you.

Sincerely,

Rick

Rick Santorum
Member of Congress

RS:mh
Enclosures

NCPA

National Center for Policy Analysis

Ten Advantages of Medical Savings Accounts

Saving Money. When people purchased medical care with funds in an MSA, they would be spending their own money rather than someone else's money. As a result, they would become careful, prudent customers in the medical marketplace.

Restoring the Doctor-Patient Relationship. Bureaucratic efforts to control costs are increasingly interfering with the doctor-patient relationship. With MSAs, patients and doctors would be encouraged to manage their own care — and would probably do a much better job.

Maintaining The Quality of Care. Bureaucratic efforts to reduce costs are also threatening the quality of patient care. To the degree that patients are spending their own money, patients and doctors will make the decisions.

Encouraging Rationing by Choice. Unless someone makes the difficult choice between medical care and other uses of money, we will be spending the entire GNP on health care. MSAs allow individuals and families — rather than large, impersonal bureaucracies — to make those decisions.

Creating a Competitive Marketplace. Most patients cannot discover the price of even routine procedures before entering a hospital and cannot read the bill when they are discharged. But patients spending their own money would quickly force radical change. In the market for cosmetic surgery and for surgery performed in the private sector in England, a single package price announced in advance is the norm.

Providing Funds for Preventive Care. MSAs would provide a source of funds for services not covered by health insurance.

Providing Funds for Health Insurance Premiums. MSAs would provide a source of funds to continue health insurance coverage when people are unemployed.

Providing Funds for Long-Term Care. MSA funds not spent during a person's working years would be available for long-term care, long-term care insurance and other post-retirement medical needs not met by Medicare.

Creating Real Insurance. With MSAs, health insurance would likely return to its traditional function — payment for risky, unforeseen, costly medical episodes — and many of the problems in the health insurance marketplace would disappear.

Creating Personal and Portable Benefits. MSAs would be the private property of the individual account holder. Their establishment would be a movement in the direction of a worthwhile social goal: making all employee benefits personal and portable.

Source: John C. Goodman and Gerald L. Musgrave, "Controlling Health Care Costs with Medical Savings Accounts," National Center for Policy Analysis, NCPA Policy Report No. 168, January 1992.

NCPA

National Center for Policy Analysis

Controlling Health Care Costs With Medical Savings Accounts

Executve Summary of NCPA Policy Report #168

Health care costs are rising in the United States for the same reason they are rising in every developed country: most of the time when we consume medical services we are spending someone else's money. Currently: About 95 percent of all hospital bills and more than 80 percent of physicians'fees are paid by private and public third-party payers.

- On the average, every time a patient spends a dollar in the medical marketplace, 76 cents is paid by someone else.
- Since we pay only 24 cents out-of-pocket for every dollar of medical care we consume, we have an incentive to continue consuming until medical services are worth only 24 cents on the dollar to us.

When health care is virtually "free," there is almost no limit to how much we can spend on it — even if we are not sick. In recognition of this fact, other countries have limited access to technology and forced hospitals and doctors to ration health care. In the United States, we are moving in the same direction, as third-party payers attempt to limit physician choice and hospital access, and increasingly dictate the practice of medicine and interfere in other ways with the doctor-patient relationship. Yet experience shows that no country has succeeded in controlling health care costs from the top down without severely reducing the quality of patient care.

Fortunately, there is a better way — one which has already been adopted in Singapore.

- Instead of having third parties pay for all medical bills, most bills could be paid by patients themselves — using health care debit cards to draw on funds in individual medical savings accounts.
- Instead of 100 percent reliance on third-party insurance, about half the nation's medical expenses could be covered by individual self-insurance.
- Instead of depending on health care bureaucracies to control costs, we could depend on the self-interest of individuals acting as prudent buyers in a competitive medical marketplace.

In substituting self-insurance for wasteful third-party insurance, people should have the opportunity to choose higher deductibles and to place the premium savings in individual medical savings accounts. Medisave accounts would grow tax free and could be used only to pay medical expenses. During retirement, Medisave balances could either be used to pay medical expenses not paid by Medicare or rolled over into an individual's pension plan.

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Under the current tax law, third-party insurance is subsidized and self-insurance is penalized. Every dollar an employer pays for third-party insurance is excluded from employee income. Every dollar an employee tries to save is taxed — at rates as high as 50 percent. To correct this distortion, we should give just as much tax incentive to deposits to Medisave accounts as we give to third-party health insurance premiums.

For individuals and families shopping for health insurance, high-deductible policies are often a much better buy even without the opportunity to establish a Medisave account:

- Increasing the deductible from $250 to $1,000 results in annual premium savings of about $400 for a middle-aged male — a good deal even if he has a $1,000 medical expense every third year for the rest of his life.

- Increasing the deductible from $250 to $2,500 results in annual premium savings of about $1,750 on a family policy — which is about equal to the insurance coverage they would forego, considering the 20 percent copayment provision in most low-deductible policies.

Although the premium savings from higher deductibles tend to be smaller for group insurance, they are still substantial. Most companies could cut health insurance premiums by one-third by moving to a $2,500 deductible — even if employees' medical care consumption did not change.

If most medical expenses were paid by people using their own Medisave funds, patients would have a financial self-interest in eliminating waste and reducing costs in the medical marketplace. Patients would acquire greater control over how their health care dollars were spent. Third-party payers would interfere in the doctor/patient relationship far less. And health insurance companies could specialize in what they do best: managing risks for rare, expensive, catastrophic medical events.

If all U.S. citizens had catastrophic health insurance for large medical bills and Medisave accounts for small medical bills, administrative costs and wasteful health care spending would be reduced significantly.

- The widespread use of Medisave accounts would reduce the administrative costs of the U.S. health care system by as much as $33 billion.

- More prudent buying on the part of patients could reduce health care spending by as much as $147 billion.

- Overall, universal catastrophic health insurance combined with Medisave accounts could reduce total U.S. health care spending by as much as one-fourth.

Self-insurance for medical bills is not a new idea. Singapore has built an entire health care system around the concept by requiring workers (and their employers) to deposit 6 percent of annual salary into Medisave accounts. Only recently has Singapore introduced third-party insurance for catastrophic medical expenses. Most of the time, people in Singapore are spending their own money rather than someone else's money when they enter the medical marketplace. And Singapore's decision to privatize its public hospitals will encourage a competitive market for medical services.

We do not have to follow Singapore's precedent of *requiring* the use of Medisave accounts. We should give people the *opportunity* to do so, however.

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Questions and Answers About Medisave Accounts

1. **What is a Medical Savings Account or Medisave account?**

   A Medisave account is a tax-free personal account used to pay medical bills not covered by insurance. Regular deposits can be made by individuals or their employer, but are the property of the individuals. Money can be withdrawn without a penalty only to pay medical expenses. Money not spent grows tax free and may be used for medical expenses after retirement or rolled over into a private pension plan. Medisave accounts ensure that people will have money to pay small medical expenses, including expenses for preventive care, and to pay insurance premiums if they change jobs or are unemployed. They give people a strong incentive to be prudent consumers of health care because people get to keep the money they don't spend.

2. **What are the financial advantages of Medisave accounts?**

   Since the premium for a high-deductible insurance policy is less than for a low-deductible policy, the savings from paying the lower premium could be used for the Medical Savings Account deposit. For example, people who choose a $1,000 deductible rather than a $250 deductible will often save more than $1,000 in reduced premiums. Thus, without spending more for health care, an individual not only has money available for small medical bills but also has an opportunity to add to tax-free savings.

3. **How do Medisave accounts affect the doctor-patient relationship?**

   Instead of having third-party payers interfere with the practice of medicine in an effort to control costs, Medisave accounts would restore the doctor-patient relationship and, at the same time, give patients and their physicians an incentive to make cost-effective decisions.

4. **How would Medisave accounts be administered?**

   Medisave accounts would be administered by qualified financial institutions in much the same way as Individual Retirement Accounts (IRAs). Individuals could exercise choice over the investment of account balances, but with the same restrictions on the type of instruments the accounts could own as now apply to IRAs.

5. How would funds from Medisave accounts be spent?

The simplest method would be by a debit card. Patients would use their debit cards to satisfy payment at the time medical services were rendered. At the end of each month, the account holders' statements would show recent expenses and account balances. No more paperwork would be needed than with any other credit card.

6. What about low-income families who cannot afford to make Medisave deposits?

If low-income families can afford to buy health insurance, they can afford to make Medisave deposits — since the primary purpose of the Medisave option is to allow individuals to divide their normal health insurance costs into two parts: self-insurance and third-party insurance. Currently, the tax law discriminates against people who do not have employer-provided insurance by failing to subsidize those who purchase health insurance on their own. Health insurance would become more affordable for the currently uninsured if they could deduct some or all of their premiums from their taxable income. It would become even more affordable through a system of refundable tax credits, which grants greater tax relief to low-income people.

7. What types of services could be purchased with Medisave funds?

In general, any type of expense considered a medical expense under current IRS rules would qualify, including postretirement health insurance and COBRA health insurance payments during periods of unemployment.

8. What tax advantages would be created for Medisave deposits?

Medisave deposits would receive the same tax treatment as health insurance premiums. Thus, under employer-provided health insurance plans, Medisave deposits would escape federal income taxes, FICA taxes, and state and local income taxes. If the opportunity to receive a tax deduction or a tax credit for the purchase of health insurance were extended to individuals, their deposits to Medisave accounts would receive the same tax treatment. Medisave balances would grow tax free and would never be taxed if the funds were spent on medical care.

9. What would prevent fraud and abuse?

In order to receive Medisave funds, a provider of medical services would have to be "qualified" under IRS rules. Qualifying should be a simple procedure, involving little more than the filing of a one-page form. But if IRS auditors discovered fraudulent behavior, the provider would lose the right to receive Medisave funds and might be subject to criminal penalties.

10. How could individuals build up funds in their Medisave accounts?

One way would be to choose a higher deductible insurance policy and deposit the premium savings in the Medisave account. For most people, a year or two of such deposits would exceed the amount of their insurance deductible. Young people and people in low-cost areas might be allowed to make even larger deposits. An alternative (which tends to be revenue neutral for the federal government) is to allow people to reduce the amount of their annual, tax-deductible contributions to IRAs, 401(k) plans and other pensions and deposit the difference in a Medisave account.

11. What if medical expenses not covered by health insurance exceeded the balance in an individual's Medisave account?

One solution would be to establish a line of credit so that individuals could effectively borrow to pay medical expenses. Repayment would be made with future Medisave deposits or other personal funds. Another solution would be to adopt the Singapore practice of allowing family members to share their Medisave funds. This would become much less of a problem as Medisave balances grew over time.

12. How would members of the same family manage their Medisave accounts?

Since family members often are covered under the same health insurance policy, it seems desirable to allow couples to own joint Medisave accounts and for parents to own family Medisave accounts. In these cases, more than one person could spend from a single account. But even if family members maintained separate accounts, this should not preclude the pooling of family resources to pay medical bills.

13. What about people who are already sick and have large medical obligations at the time the plan is started?

These people might be harmed by a sudden increase in the health insurance deductible unless transitional arrangements are made. Most would benefit from a high deductible in the long run but suffer financially at the outset.

One solution is for employers to extend credit to employees who are especially disadvantaged, with the loan to be repaid from future Medisave contributions. Another solution is for employers to bear part of the burden of these expenses (in the case of special hardship) during the transition period.

14. What about people who have a catastrophic illness with large annual medical bills that last indefinitely into the future?

Most of these people would be disadvantaged if they have an annual deductible. A better form of health insurance is one with a per condition deductible, in which case the deductible would be paid only once for an extended illness.

15. Are there circumstances under which individuals could withdraw Medisave funds for non-medical expenses prior to retirement?

A reasonable policy is to apply the same rules that now apply to tax-deferred savings plans (e.g., IRAs, 401(k), etc.) Thus, non-medical withdrawals would be fully taxed and would face an additional 10 percent tax penalty.

16. How do we know people would not forego needed medical care (including preventive care) in order to conserve their Medisave funds?

We don't. The theory behind Medisave accounts is that people should have a store of personal funds with which to purchase medical care. But since the money they spend is their own, they have strong incentives to make prudent decisions. Undoubtedly some of these decisions will be wrong. But many decisions made under the current system also are wrong.

Since we cannot spend our entire GNP on health, health care has to be rationed in some way. Under the current system we are moving toward the European solution — with rationing decisions made by a health care bureaucracy. The alternative is self-rationing, with individuals making their own choices between money and medical services.

17. Given the increasing complexity of medical science, how can individuals possibly make wise decisions when spending their Medisave funds?

One thing people can do is solicit advice from others who claim to have superior knowledge. For example, most large employers and practically all insurance companies have cost management programs in which teams of experts make judgments about *whether, when* and *where* medical procedures should be performed.

These experienced professionals might play an important role in helping patients make decisions about complicated and expensive procedures. But the professionals' role as advice-givers should not include decision-making power. We should let the experts advise and the patient decide.

Moreover, the fact that individuals maintain Medisave accounts does not preclude their taking advantage of employer-negotiated price discounts from providers or managed care programs.

18. Given the problems large employers and insurance companies have in negotiating with hospitals, how can individual patients possibly do better?

The reason large institutions have so much difficulty negotiating with hospitals is precisely because the institution is not the patient. And the reason why patients spending their own money would wield effective power is the same reason consumers wield power in every market — they can take their money and go elsewhere. In the field of cosmetic surgery, for example, consumers can obtain package prices that are well below the prices charged for comparable procedures at institutions dependent on third-party reimbursement. Moreover, the fact that individuals maintain Medisave accounts does not prevent them from using employers as bargaining agents.

19. What would happen to Medisave account balances at retirement?

People should be able to roll over their Medisave funds into an IRA or some other pension fund. Thus, money not spent on medical care could be used, after taxes, to purchase other goods and services. Alternatively, Medisave balances could be maintained to purchase postretirement health care, long-term care or long-term care insurance.

20. What would prevent wealthy individuals from misusing Medisave accounts to shelter large amounts of tax-deferred income?

An individual's total tax-advantaged expense for health insurance plus Medisave deposits could not exceed a "reasonable" amount. One definition of "reasonable" is an annual Medisave deposit which equals the deductible for a standard catastrophic health insurance policy.

21. What about people who join HMOs?

They would have the same opportunities as those who join conventional, fee-for-service health insurance plans. Note that because many HMOs are now instituting deductibles, HMO members will have additional incentives to acquire Medisave accounts. Their HMO premiums plus their deposits to Medisave accounts could not exceed a reasonable amount, however.

22. Under employer-provided plans, would employees have a choice of deductibles?

Allowing employees to make individual choices makes sense. Over time, different people will have different accumulations in their Medisave accounts and, thus, will likely have different preferences about health insurance deductibles. However, under current law, employers have the option of fashioning employee benefit plans, and it is in their self-interest to create a plan that is most pleasing to employees. As a practical political matter, it seems wise to continue that feature of the current system.

23. What would happen to the Flexible Spending Accounts now available to some employees?

Medisave accounts would replace Flexible Spending Accounts (FSAs) under employee benefits law. Currently, employees who make deposits to FSAs must "use it or lose it," typically within twelve months. Similar deposits made to Medisave accounts would have no such restrictions.

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of the Assistant Secretary
for Legislation

Washington, D.C. 20201

JUN - 2 1993

Honorable Rick Santorum
House of Representatives
Washington, D.C. 20515

Dear Mr. Santorum:

We are enclosing the answers to the follow-up questions you presented after the Secretary's testimony before the Ways and Means Committee on March 10.

A copy has also been forwarded to the Ways and Means Committee for inclusion in the record of the hearing.

Sincerely,

Jerry D. Klepner
Assistant Secretary
for Legislation

Enclosure

[THE RESPONSE TO MR. SANTORUM'S FIRST QUESTION ON HEAD START, HAS BEEN RESPONDED TO IN THE ANSWER PREVIOUSLY PROVIDED TO MR. ARCHER. THE RESPONSES TO THE REMAINDER OF HIS QUESTIONS, ARE AS FOLLOWS:]

Response to 4 of the 5 Questions Submitted by Rep. Santorum on Health Care Reform (See Letter)

I appreciate knowing of your support for medical savings accounts. While medical savings accounts were reviewed during the course of our deliberations on health care reform, they will not be part of our proposal. We believe Americans are better protected from catastrophic health care expenses through their insurance that pools risk rather than individual savings efforts. In addition, comprehensive health care protection must make primary care and preventive care services available to all Americans. These services enhance both the quality and cost effectiveness of health care by reducing the incidence of more serious, preventable health conditions.

Let me now turn to your questions regarding health care reform. The President has stressed that in developing his health care reform plan emphasis would be placed on innovative private sector initiatives. It is our intent to maintain and build upon community or private programs that have been able to expand access to health care services for underserved populations. One of the programs you asked about, The Caring Program in Western Pennsylvania, is an excellent example of the type of program we want to see continued. The program seeks to ensure that children of the working poor have access to necessary primary care services and dental care. In addition, the program places a strong emphasis on the education of both the parent and child regarding health care services. Programs like this are crucial if we want our children to grow up healthy. While no final decision have been made in health care reform, we anticipate that you will see a strong emphasis on primary and preventive care services especially related to children.

With respect to the Special Care program offered by Blue Cross Blue Shield in Pennsylvania, as you know that program permits individuals to purchase a "basic" benefits package at a very low rate. Programs like Special Care do provide some coverage for individuals who would otherwise have no other means of obtaining health care insurance. However, in order to make the benefit package "affordable" important health benefits are sacrificed. In fact, such insurance products have met with only marginal success in states where they have been offered primarily because the benefit package does not provide adequate coverage.

Once again, we believe to the extent possible we must provide access to a comprehensive benefit package especially for our nation's children. In developing the package we will be striving to guarantee that all Americans have comprehensive, affordable, cost-effective health care services.

Mr. ANDREWS. Good afternoon, Madam Secretary. Delighted to have you here before our committee. I have got the committee room to myself now. I am in charge.

Secretary SHALALA. Anything you want to know, Congressman Andrews, I would be happy to answer.

Mr. ANDREWS. One of the things that has been a high point in my career in the House, and certainly on the Ways and Means Committee, was reforming the welfare system for the first time. And it was largely due to the help of then Governor Bill Clinton that we were able to pass the first real major welfare reform.

I believe history will look back on the Reagan years and see welfare reform as being one of the hallmarks of his domestic policy. The first major step to encourage people on welfare to go to work, to get a job, is to deal with the difficult problem of securing and, collecting child support. It is an issue that has remained one of real passion with me.

Our Subcommittee of Human Resources has graded various States, mine having some of the most progressive child support enforcement laws while doing one of the poorest jobs of collecting child support in the Nation. That is true of many States across the South. States that have low welfare benefits to start with don't do a particularly good job of collecting child support payments.

I just want to express to you how enthusiastic I am to have President Clinton eager to fulfill the promise of that legislation. If we are going to ask the young mother to get a job or seek training, we have to fund programs adequately to ensure there is day care and child care for her to allow her to get off of welfare.

Some of the things we have tried in child support enforcement are, one, mandatory wage withholding and, faster and better monitoring in local communities.

One such program in San Antonio has worked very well as a pilot project, by putting more money into those areas and focusing on delinquent child support payments to go after those spouses who aren't making their payments.

One amendment I had in the tax bill H.R. 11, vetoed by the President, would encourage——

Secretary SHALALA. Previous President.

Mr. ANDREWS. The previous President—would encourage the reporting of people in arrears to credit bureaus in particular States. We found it a successful way to accelerate payments. I would like to write you a letter regarding the particular amendment if you are not aware of it for your discussion and thought, and I hope that you will support it as well.

Secretary SHALALA. We will support it, Congressman.

Mr. ANDREWS. Well, thank you.

I would like to have your opinions regarding this issue of welfare reform. I think Mr. Santorum did raise a point that is worth discussing, being that what Governor Clinton, now President Clinton, has tried to do is encourage people with sticks and carrots to work their way out of welfare and by using mandates to encourage them to find a job or seek job training.

What do you think we need to do? What steps do you see for the future that the administration and Congress need to take to prepare ourselves? What specific things should we be looking at in

order to move this process ahead and really make welfare reform what it was intended to be?

Secretary SHALALA. I think that our philosophy is that work is the centerpiece and the expectation of every American and that they are going to go to work to support themselves and to support their families. And that whatever the public incentives are, they have to support that concept as opposed to the current system which supports the concept of staying away from work because the benefit package is higher than what you might get from an entry level job, which is particularly true of health care benefits. So it is also the messages that we send.

Young people must grow up in this country taking responsibility for their own futures as well as their own bodies. And if someone chooses to have a child or if there is an unwanted pregnancy and she makes the decision to carry it to term, she has to understand that one part of her responsibility—and we will help with child support and child care—is to go to work; and two, that we are not going to have long-term support in this country of heads of households and their families who are not working. But having said that, then we must make it possible for everyone that works in this country to be able to bring their family above the poverty level.

They ought to not have to raise their children in poverty. We also have to hold parents, absent or not, financially responsible for their children, and therefore child support enforcement must be a bold and much stronger program than it currently is. Using the IRS, notifying credit agencies, making sure that we have a nationwide system that can track people, so there are lots of changes that we need to make there.

Mr. ANDREWS. If I could interject, it seems that in this area of child support enforcement, we need to be more experimental than in the past. There have been things that have worked well, and those that haven't. I know from my personal experience that generally the youngest, most naive and least experienced prosecutors are put into that section. Collecting child support, and refocusing our attention on those issues, will put tougher kinds of people into garnering some of these back child support payments. We must also be experimental in different areas, trying things that have worked and getting rid of those that haven't.

Secretary SHALALA. As you well know, in a number of States there have been experiments which give us some hints about what a national program ought to look like. Obviously streamlining the establishment of paternity, developing of a national data base for noncustodial parents, these things will help as part of this overall strategy, providing people who can work with training and the kind of support system that they need for their children so they can move off welfare. And so when we send the message: this is going to be a time-limited, transitional program; that people do not just fall into a hole; that there are opportunities to get training and to have jobs; but more than anything else to change the culture of welfare. We want to make it very clear that we are talking about transitional programs, not long-term programs, and that we are prepared as a Nation to provide people with the support, with earned income tax credits so when they do go to work they do not have to bring up their family in poverty. But beyond that people

also have to take responsibility for their own lives, and I believe that responsibility is a centerpiece in this change in attitude and culture that this new program has to support.

Mr. ANDREWS. Let me ask you to focus your attention on another issue. Senator Bradley and I last week introduced a bill to raise the tax on tobacco products to a dollar nationwide. What we know very clearly is that tobacco kills about a thousand people every day, and the American taxpayer spends $24 billion a year in direct costs to take care of people that get sick from smoking. New customers who take the place of old customers who have died or managed to quit their habit, tend to be under the age of 19 and 60 percent of new customers are under 16 years of age.

In this debate on health care reform, I am curious what your views are about tobacco use and excise taxes on tobacco. In addition to mitigating the costs created by sick people and also discouraging young teenage smoking, is there a role for the tobacco excise taxes?

Secretary SHALALA. It certainly is something that everyone is looking at currently. Particularly there have been a number of experiences both in Europe, in New Zealand, I think, as well as California where there has been the most interesting kind of experience that tells us a lot about the relationship between price and young people starting to smoke. California undertook a very powerful ad campaign to change the behavior of young people, which was paid for with a tax. It looks like it is starting to have an effect. So we are obviously very interested as part of health reform in trying to reduce costs, and because we are very interested in prevention, and in primary care, in trying to reduce the number of people that start smoking. So for us it is not only an interest from a financing point of view, but similar to your interest, our interest in reducing the number of young people that start smoking in the first place.

Mr. ANDREWS. Do you favor raising the excise tax on tobacco?

Secretary SHALALA. I think that the President has not said specifically that he is going to buy off on that tax, so it would be presumptuous of me to say that I personally am. I do not want to leave with you any question in your minds about the relationship between price and young people starting to smoke and our need obviously to find an array of taxes, some of them health related would be helpful.

Mr. ANDREWS. We have a five-minute vote now. The committee will stand in recess for about ten minutes. At the time, the Chairman will return and we will continue with your testimony. Thank you.

[Recess.]

Chairman ROSTENKOWSKI. As you can see, Madam Secretary, we have a relay team here that tries to keep these hearings going so we don't impose too much time on you and your valuable schedule.

Secretary SHALALA. Thank you.

Chairman ROSTENKOWSKI. So I am sure that many of the members will be back. This is the last of a series of votes. I am sure that many of the members will be back and will once again join me in questioning you about where you think we can go. I am concerned, Madam Secretary, about enacting substantial medicare savings in the absence of establishing a national health care cost

containment program. Many private employers believe that providers make up medicare cuts by increasing payments to private payers.

Do you believe that is true, and won't these Federal savings simply result in higher costs for private sector employers?

Secretary SHALALA. Only if the private sector employers are willing to pay the bill, and I think that, Mr. Chairman, to be more responsive to your general point, we obviously are caught here. It was necessary for the President to make a serious statement about deficit reduction. He obviously had to look across the government with all of us. We felt that we went through the Medicare program and the Medicaid program with a scalpel to be as sensitive as we possibly could about the nature of the slowing down of the increases that we were taking.

We are not geniuses at this, and if there are any suggestions you or your committee or the staff have, we will be happy to consider them in terms of the obvious cost shifting that has been documented extensively. My hope is that there will be some slowing down of cost shifting. Again, my point is that it is a management decision to cost shift, and it works when someone at the other end is willing to write the check and pay the bill, but I share your concern.

I want to repeat what I said in regard to large, urban, teaching hospitals, about rural hospitals, and I think that as we went through we tried to be sensitive to that. Perhaps we were not sensitive enough.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. Thank you, Mr. Chairman. Welcome, Madam Secretary.

Secretary SHALALA. Thank you.

Mr. COYNE. Is there a relationship between the proposed medicare cuts in the budget and the President's commitment to enacting and implementing a national health reform program?

Secretary SHALALA. Only in the sense that the people that are managing all of this are part of both discussions. And in the process of looking through the Medicare program to see where we could slow down some of the increases, we were very conscious of the fact that we were not going to make systemic changes in the nature of the program or the nature of the delivery system. And we attempted to protect beneficiaries as part of the process. So in the sense that we did not go through the program with a meat axe to fundamentally change the program because we knew that health care reform was coming close behind, the answer is, yes.

Mr. COYNE. Okay. The President has proposed that starting in 1995 the Part B premium beneficiaries are going to be paying 27 percent of the premium instead of 25, and the question I have, was there any thought given in developing that plan to having the higher income people in the program absorb more of the cost of the Part B payments?

Secretary SHALALA. I believe that what we did there was sort of straight line the decision the Congress already made, so what we relied on was the good judgment of the Congress in establishing that and simply stretched it out over a longer period of time. In

fact, it is a little less than it would have been under the original congressional decision.

Mr. COYNE. So I presume that will set a precedent for all future ideas of the Congress, that you will accede to that as well?

Secretary SHALALA. To the extent they are thoughtful and insightful, we will be happy to stretch them out over a longer period of time as part of our recommendations to you.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman. I want to join you, Mr. Chairman, and my colleagues in welcoming you to the first of many visits, Secretary Shalala. Your reputation for hard work and decisiveness precedes you, and you are going to need it. You are going to be faced with deficit reduction, health care and welfare reform in, I guess, six months.

Secretary SHALALA. Easier than trying to run a football team, Mr. Stark.

Mr. STARK. It might very well be. I look forward to working with you, as I know our committee does. I know that you are going to be faced with, as you await confirmation of some of your additional staff and as we await the budget process to grind through, we are all sort of sitting here on tenterhooks trying to figure out what the final product of budget reconciliation and health care reform will be. I want to state that it has been our committee's record and policy in the past to meet the budget requirements, and we have promptly done so. Under the leadership of the Chairman, both in the letter and the spirit of the budget resolution. However, we have enjoyed, and I hope we can continue to enjoy flexibility or, if I could put it in the words of distinguished gentleman from Texas, Mr. Pickle, a little wiggle room, so that if we find out that there are unintended consequences of a political nature that we might be able to move the chairs around on the deck of a ship that is going to sit a little bit lower in the water as a result of budget cuts.

I would hope that the Secretary and her staff would indulge us in a little wiggle room as we proceed to meet the budget requirements and the reform changes that we anticipate will be necessary in the health care program. I have nothing more to add or really to inquire at this point because I think your administration has done a wonderful job of iterating and reiterating the policies for which it stands, and I think the American people are comfortable with it. I know I am.

It has often been said that the devil is in the details, but that is what you pay us to do, and I would just like to suggest that this committee will work with you to see that we accomplish those goals. I was interested to learn that we have had a temporary setback in our schedule as a result of the Federal Court about an hour or so ago suggesting that we have got to halt the task forces going on at the White House because of a sunshine law, but I suspect that we will find a way or you will find a way to get back on stream with that, and we will look forward to the specifications or legislation that you bring to us. Thank you, and, again, welcome to the committee.

Secretary SHALALA. Thank you very much, Congressman.

Chairman ROSTENKOWSKI. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman. Nice to see you, Madam Secretary. Just two quick items to reaffirm what has already been mentioned and then also a basic question. First of all, as far as the graduate medical education cuts are concerned, that has been brought up. You understand what the problem is, it is disproportionate to some of the great teaching centers, and I think it is unfair putting this on a national average basis. You said because Mr. Pickle brought it up that you were going to look into it, and that is good enough for me.

The other thing, as far as the health care system is concerned, really has to do with telecommunications. If I understand correctly you are moving in the direction of managed care, and if that is the case, it is going to be difficult for some of the rural areas because there is no option, there is no alternative, there is no place to go if you don't like one particular system.

Something which we have tried is the concept of linking smaller hospitals with larger teaching units. I know Ed Markey brought this up in one of his hearings and some of the statistics are pretty breathtaking. For example, the Arthur D. Little study said if you linked some of the smaller or rural hospitals up with some of the great medical centers on a national basis, you could save something like $36 billion a year.

Now, I have no idea whether those figures hold water or not, but that is from a reputable firm, a reputable study and a reputable Congressman, so I urge you to look into that because I think there is some real gold to be mined there.

The last question, it is really a question, the only one I have, has to do with something which was brought up yesterday, and it reminded me a little bit of some of the stuff that Dick Darman talked about and Leon Panetta mentioned. I don't want to quote him directly because I am not sure exactly what he said, but the thrust, if I understood it, was something like this: That if you took medical costs, froze them, added on cost-of-living, added on top of that 3 percent, added on top of that demographic changes, that you could save virtually trillions of dollars, and that may be the way you would be going. Do you have any comment on that?

Secretary SHALALA. Not specifically because I did not hear specifically what Mr. Panetta said, but if we had done that, for example, to try to save money with that kind of cap, we would have destroyed the medical education and the rural hospitals because the kinds of adjustments we made for them are substantially more than that system would suggest. We certainly will look at all sorts of alternatives for cost containment of the overall system as part of health care reform, and that includes some short-term considerations of so-called freezes, but our preference here for these deficit contributions was to go through with a lot more sensitivity to rural areas and to medical education, for example.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Payne will inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman. Welcome, Madam Secretary.

Secretary SHALALA. Thank you.

Mr. PAYNE. I know you will do well, and I look forward to working with you. I also want to thank you and thank President Clinton

for what I think is a very bold economic plan and one which I certainly intend to support, but I would like to use this time to talk just a little bit about health care reform because I think that is so important as the next step in terms of our overall economic plan. I am from a predominantly rural area, and we spend a good bit of our time looking for primary care physicians that might serve medically underserved areas.

We have come to realize that this is not a problem that is unique just to rural areas, but there is a real shortage of primary care physicians in this country, and the mix of primary care physicians and specialists is different in this country than it is in most others. We have looked at how we might involve our State and locality in solving what we think is a pretty important issue for health care reform and health care cost containment. The three medical universities in Virginia have come up with an innovative idea or innovative concept which is a project that has as its goal producing at least 50 percent primary care physician graduates by the year 2000.

This is significant because last year I think they had 18 percent of the graduates were primary care, so this is quite a change in a relatively short period of time. The only way that this will work is if your Department will cooperate with them in terms of some flexibility primarily in the area of graduate medical education reimbursement formulas. I am not asking that we spend any more money but simply that there be some kind of flexibility that might be permitted in the funding formula which would be agreed to by all these recipients simply for them to change their residency training emphasis more toward primary care, and to that end we are having a meeting next month with these university officials and members, senior members of your Department to discuss this, and I guess my hope is that you could be supportive of what it is that we are trying to do because I think it is a very good pilot program and it is significant for Virginia, but it may be very significant for the Nation.

Secretary SHALALA. Thank you very much, Congressman Payne. I think your point is very well taken. This proposal actually rewards primary care residencies. We have tried to begin to tilt back toward primary care residencies, and you will find us increasingly supportive of using the medical education dollars to make certain that we make a proper commitment to primary care physicians. I think the major medical societies in this country fully understand that we have gone overboard in one direction. We need to put an emphasis on primary care, but once those doctors graduate, the reimbursement schemes, the whole system needs to run its incentives so that there are also some economic incentives for primary care physicians that help to support them as they go to practice medicine in inner cities or in rural areas, in places where there is a dearth of primary care physicians. But just as important are other health professionals because, as you well know, in rural areas in this country which have made enormous efforts to attract primary care physicians, while they may get them for a short period of time without the reimbursement system and the other kinds of support, we need to do other kinds of things to keep them.

In this proposal is new technology developed by NIH that will give primary care physicians out in rural areas a way of accessing great teaching hospitals and the kind of library and backup support that they need. The development of these new computerized systems are very important in keeping people up to date, but more importantly feeling that they have the support that they might have in a more urban area. But I think more than anything else the economic incentives have to run in that direction, and we have to change our philosophy and our culture in terms of what we hold up to be high status.

Primary care family physicians and preventative care have to increasingly be high status in our society, and where the government puts its resources has a great deal to do with that kind of stature. I think that over the years and within the health care reform package, as well as at least as much as we could do here, you will see that kind of emphasis.

Mr. PAYNE. Well, we are very pleased that these fine hospitals in Virginia have made this decision and very much look forward to working with you and your Department. Thank you very much.

Secretary SHALALA. Thank you.

Chairman ROSTENKOWSKI. Mr. Lewis will inquire.

Mr. LEWIS. Thank you, Mr. Chairman. Madam Secretary, I want to welcome you. I must tell you, and I really believe you are the best person for this great task.

Secretary SHALALA. Thank you, Congressman.

Mr. LEWIS. You have taken on a great and tremendous task, and I want to wish you luck and courage.

Chairman ROSTENKOWSKI. Madam Secretary, don't let all this go to your head.

Secretary SHALALA. I figure it is short term at the beginning.

Mr. LEWIS. Madam Secretary, I will support you and the President in your efforts to be bold and to bring about real change. Madam Secretary, I want to know, will you use your position and your great influence to get this President to issue an executive order banning smoking in all Federal buildings?

Secretary SHALALA. Congressman, such a proposal, as you know, has been under consideration over the years, and as part of health care reform, we are looking at proposals that have to do with banning smoking in Federal buildings. I believe that Mrs. Clinton has already indicated the White House has banned smoking, and most Federal buildings actually have banned smoking already. It has been individual departmental decisions, and I think that the time has come for serious consideration of an overall ban, and my Department is indeed reviewing that.

Mr. LEWIS. Madam Secretary, I know you don't have any influence or control over Capitol Hill, but maybe that spirit will move around here also.

Secretary SHALALA. I think that a healthier Congress would be good for all of us.

Mr. HANCOCK. Would the gentleman yield. Maybe we ought to have a smoking tax and also an overweight tax, an obesity tax. I appreciate your comments. Us smokers recognize that we have got a real problem. Thank you.

Mr. LEWIS. Well, let me say to my colleague on the other side, some of us are working on that.

Madam Secretary, I would like to ask you about long-term care. People living longer, many well into their 80s, I think most of us face long-term illness when we get older. We all know that nursing home payments are a tremendous drain on the medicaid budget. At the same time paying for long-term care is extremely expensive. Do you have any thoughts or comments on what we might learn from the medicaid experience, how we might begin to better address long-term care?

Secretary SHALALA. I think that long-term care is the next great issue for those of us that are concerned about the aging process, and this country is going to have to confront that issue over the next few years. We are looking at the issue. In fact, we have a working group looking at that issue as part of health care reform, and the first pronouncements and the first ideas may well come out as part of our health care reform package. It is indeed very expensive, but it depends on how you do it. It depends on whether long-term care is in part a partnership between families and the government. It depends on what kinds of facilities are used and whether people are supported to stay with their families in their own homes and at what point they need to change their shelter arrangements. It depends on how sophisticated we are about the need for different kinds of shelter arrangements depending on the aging process.

We have a long way to go, but we have some of the country's leading authorities and most thoughtful people coming into the Department to help us think this through. I should point out that the new Assistant Secretary for Aging, Professor Torres-Gil from the University of California at Los Angeles, is indeed concerned about this issue.

Our desire to upgrade that Office of Aging to an Assistant Secretary level should reflect our concern about taking on issues of long-term care. With an office and with the personnel of such stature and thoughtfulness we are prepared to take on that issue.

Mr. LEWIS. Thank you very much, Madam Secretary. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Hancock.

Mr. HANCOCK. Madam Secretary, in candidate Clinton's book titled, "Putting People First," he said "lift the Social Security earnings test limitations so that older Americans are able to help rebuild our economy and create a better future for all." This repeal of the earnings limit test on Social Security was not included in any part of the President's plan. Yesterday, when I asked OMB Budget Director Panetta about it, his response was that everything must be on a pay-as-you-go system. There have been estimates by Aldona and Gary Robbins, former Treasury Department economists, that abolishing the earning limits would net the Government $140 million in revenue.

What is your feelings about the earnings limit and why was it not included in the President's plan as he indicated in his book?

Secretary SHALALA. I think that eliminating the retirement earnings limit for beneficiaries age 65 to 69 has been widely discussed over the years, as well as by the President. Those in favor generally believe that it discourages some people from continuing to

participate in the labor force, and those opposed are concerned about allowing people to receive all of their retirement benefits in addition to unlimited earnings, so there has actually been a debate going on. If we eliminated the earnings test, the estimates are that it would cost us about $24 billion over the first five years. That is a very expensive investment. It is a public policy call, a political call.

I can tell you that from Social Security's point of view, at least for people as they are coming off a job and perhaps starting another one or picking up a part-time job, it is tough to administer, and it ties us up, at least for the first year, with lots of paperwork and education explaining to people what they can and cannot earn. I think that this is an issue that will evolve, and as we talk about a variety of issues from long-term care to other kinds of Social Security issues, we certainly will consider this one.

I think it is an expensive step for us and not one that the President obviously included at this moment, but one should not assume that we are not going to get a careful review of that idea at some point in the administration.

Mr. HANCOCK. Well, is it not true that the same paperwork exists for people over age 70 as would exist for people age 65?

Secretary SHALALA. It is the first year that people are coming off in terms of explaining it to them.

Mr. HANCOCK. Well, I didn't think it was that complicated. I am 63, and it didn't take them very long to explain it to me.

I have got one other question. Under the GAO reports, various health-related savings have been suggested. Are you going to be implementing some of the ideas they suggested, and if so, how many of them?

Secretary SHALALA. We are in the process of reviewing a variety of Inspector General and GAO reports that have made recommendations. Some of those recommendations have already been implemented and others will require some reorganization as we get in the new senior people. That is precisely what they are doing. We need to make sure that we eliminate waste, fraud, and abuse which eats up needed dollars for other kinds of programs, and simultaneously we need to make sure that we have new systems in place that reduce the possibility of misuse of these government programs.

Mr. HANCOCK. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jefferson will inquire.

Mr. JEFFERSON. Good to see you, Madam Secretary. I want to ask you two or three, I think, rather short questions. The first has to do with the outpatient services proposals you have. It is page four under Medicare part B, and currently certain outpatient services are paid at 94.2 percent of costs, and the proposal is to extend that reduction and further reduce levels to 90 percent, bringing it consistent with the payments for outpatient capital costs.

I want to ask this: Here you are treating outpatient and inpatient cuts either as meritorious or as less worthy, and at the same time you are treating them both the same. Shouldn't there be an emphasis on outpatient care here? Wouldn't it be a way to save money in the program and shouldn't we encourage outpatient care?

Secretary SHALALA. Actually outpatient care has been rising more sharply, and this was really an attempt to slow down some of that growth rate. For instance, since 1985 outpatient growth has been two or three times faster than the growth of inpatient services, so to be fair that is why there is a differential in terms of our treatment.

Mr. JEFFERSON. But isn't it a good thing to foster outpatient services? Usually it turns out that they are as effective, less costly, less time spent, less medicine involved, you know, less health care support, health care provider support, that sort of thing. I would just like to have you look into ways that we might foster savings by pushing more support to out care patients.

Secretary SHALALA. I think we would be happy to review that. I should point out that outpatient services outside of the hospital setting in other kinds of settings are cheaper than the kinds of services that are provided within the hospital setting. In this case there were simply very stark increases. Instead of taking cuts we are trying to slow them down a little bit.

Mr. JEFFERSON. Okay, my second question is: In New Orleans approximately nine physicians are handling 60 percent of the outpatient medicare, medicaid patients there. It may be an astounding figure there, but that is about what we would have. I would hope the cuts proposed wouldn't adversely affect the physicians who are providing this sorely needed service to people in the inner city. What do you expect the effect will be on those few doctors who are providing that great deal of service?

Secretary SHALALA. We did try to be sensitive to those doctors in inner cities that are providing primary care services in particular and tried to be very sensitive as we went into slowing down of the increases. And if you would like to discuss those, I would be happy to send my staff over to talk to you about how we went through and did that.

Mr. JEFFERSON. Thank you.

Secretary SHALALA. You are welcome.

Mr. JEFFERSON. I am trying to envision, because under the managed care concept, I know it isn't strictly formulated yet, and I know it can be formed a number of different ways, but PPOs and HMOs haven't ordinarily taken into account the specialty care hospitals. They haven't been able to service them or include them in their coverages. How would they be handled in a managed care concept?

Secretary SHALALA. Well, that is one of the challenges of managed competition, to make sure that the system is flexible enough to handle nontraditional settings. You can be assured that we have had conversations about that, and we are well aware of our need to provide that kind of sensitivity.

Mr. JEFFERSON. So the children's hospitals and the eye, ear, nose and throat hospitals all will be covered under this managed competition hospital?

Secretary SHALALA. Exactly.

Mr. JEFFERSON. Thank you, Madam Secretary. I appreciate it.

Chairman ROSTENKOWSKI. Mr. Kleczka will inquire.

Mr. KLECZKA. Thank you. Madam Secretary, we are running out of questions at this point. Do you have any questions?

Secretary SHALALA. How is my basketball team doing?

Mr. KLECZKA. Not too bad. Things are looking up. We talked somewhat this afternoon about the disability backlog, but what hasn't been mentioned is an impending problem with the Disability Insurance Fund. Are you aware of that particular problem and do you know when we are going to be suffering a short-term liquidity in the fund and what your resolve might be?

Secretary SHALALA. We will actually be making a recommendation on that, and I am not prepared now to present that, but we are indeed taking a look at that, and those issues have been brought to me recently.

Mr. KLECZKA. Will that be coming forward this year?

Secretary SHALALA. Yes, I expect it to be coming forward this year.

Mr. KLECZKA. Also we discussed some of the innovative programs coming from the States like Maryland and our own State of Wisconsin. Naturally we want a universal or an integrated type of system for a health care reform, but I think, as you have indicated, some of those programs should be looked at and possibly incorporated, and I appreciate your answer there.

The last concern and the last question I have is relative to a question which has come up by groups visiting members of this committee and others relative to taxation of health care benefits either above a certain dollar amount or above a certain benefit amount. What are your views of any type of a health care reform package relative to imposing a tax on health care insurance?

Secretary SHALALA. Well, obviously we are looking at the possibility of taxing benefits above the basic package as a method of financing the system, and there has been some discussion by President and Mrs. Clinton in the press about that topic. What I could say to you is that whatever we do on taxation, it has to be a fair system, but the fundamental themes have to hold that everybody gets the same basic benefit package; that everybody has access to quality care; that we include the working poor that now do not have coverage; and that we eliminate any requirement that takes into account what previous conditions were. So trying to do that and simultaneously put together a tax package that does not hit the middle class is going to be very complicated, but that is what we have in mind.

Mr. KLECZKA. What is the goal or the rationale for a taxation policy if, in fact, an employer chooses to offer a package above the basic, whatever that might be? Why should we try to not only disallow it but provide a disincentive for something like that?

Secretary SHALALA. Well, you know, there is the fundamental philosophical issue here of additional benefits and whether in the process of trying to finance the system we need to recapture any savings on the private sector side as part of the financing package. All I can say to you is that some scholars have suggested that one way of doing that is to tax benefits above a certain minimum level, and the philosophy there is to try to recapture some revenues to finance the basic benefit levels so you can expand coverage.

Mr. KLECZKA. Thank you very much.

Chairman ROSTENKOWSKI. Mr. McCrery.

Mr. McCRERY. Thank you, Mr. Chairman. Secretary Shalala, there was an article in The Washington Post recently—I don't usually use the Post as a source—but I will assume they were factual in this case. The article cited a recent study by Foster Higgins of employers' health care costs and the increase in employers' health care costs last year. They said they increased 10.1 percent, whereas over the past several years the average rate of increase on an annual basis was 14.9 percent, so it is a substantial reduction in the rate of increase in employer health care costs. Are you familiar with that study and——

Secretary SHALALA. I did read that study, and I am aware that there has been some slowing down in the system in general, and that is what that——

Mr. McCRERY. How do you account for that?

Secretary SHALALA. I think there is a limit to what people are prepared to pay, and there is some recognition in the system that we cannot continue to pay large increases. I think managed care in some places is having an impact, as there is a squeezing down around the country, but more than anything else companies have to keep themselves competitive. These soaring health care costs have made it very difficult for them to do that, so there are some people in the system simply saying, no, to increases.

Mr. McCRERY. So that is the private marketplace working?

Secretary SHALALA. Pardon?

Mr. McCRERY. Is the private marketplace working?

Secretary SHALALA. It may be that parts of the private marketplace may be working, and one of the reasons that the administration is considering very much a private sector model is that there is some faith that a private sector model, combined with perhaps some public sector input to protect those areas in which private sector model or competitive model would not work is, in fact, the way to try to keep health costs or at least the increase slowing down.

Mr. McCRERY. Also on that study, it is interesting to note that the State of Maryland, which we have heard a lot about in these hearings from Mr. Cardin and now Mr. Kleczka, had its effective rate going up by over 14 percent, so it was much higher than the average of employers in other States, so maybe, just maybe, hospital rate regulation is not the answer to our problems.

Secretary SHALALA. And I do not know what is in that, whether it has been the downturn in the economy that caused more people to get on to their system or what the explanation is. But there are clearly some things going on in the system, some good and some bad, and that just simply rejustifies the reason to look at the whole system, to try to get control of it, and to try to develop a uniquely American model based on what we have done in terms of building this model in the private sector, combined with some things that we need to do to cover areas that might not be covered.

Mr. McCRERY. Thank you. I am glad that you all are looking at a private sector free market approach.

Mr. STARK. Would the gentleman yield?

Secretary SHALALA. Part of the tradition of our party.

Mr. McCRERY. I would be glad to yield to my Chairman.

Mr. STARK. In the absence of my colleague, Mr. Cardin, I just would like to clarify the Maryland situation which I know he is quite proud of and justifiably so. While the study you cited shows that the insurance rates may very well have gone up 14 percent, the hospital rates, which are really that part that is unique to the Maryland system, didn't go up anywhere near that. They went up less than the others in the country. All the other factors may have raised it, but I want to give credit to Mr. Cardin.

Mr. MCCRERY. In fact, you have made my point, that by squeezing one sector of the health care industry you don't necessarily solve the problem of health care costs, and this study, in fact, was a gauge of total employers' costs for health care.

Mr. STARK. The gentleman is quite true. Just today Maryland announced they are going to squeeze the rest of the sector, so they are going to try to get it all now.

Mr. MCCRERY. These other States aren't squeezing anything, and it is the private sector at work. They have got their rate of increase down to 10.1 percent, so I am glad the administration is looking at a private sector approach. Maybe, just maybe the private sector can solve this problem with some help from us.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman. Welcome. We really feel good having you here. I wish that we could just freeze these reimbursement rates and get on with a comprehensive plan because I just hate to run the gauntlet of my New York hospitals twice, especially in the same year, but do you have any idea as to what the Federal health care costs are as it relates to drug and alcohol abuse?

Secretary SHALALA. You mean what we spend on drug and alcohol abuse?

Mr. RANGEL. The illnesses related. I am told in my local hospital that every child born addicted to drugs and to crack costs $5,000 a day. I am informed that my hospital rates are $600 a day. I am informed that a homeless person addicted that contracts tuberculosis can cost $10,000 a day because of all the special equipment that is necessary to contain those patients. It is my understanding that the most expensive health care that you can get in the entire world is in my emergency rooms where people come in for the first time, many of them, seeing a physician and we have the gunshot wounds, we have diabetes, strokes, and all of that related, and it just seems to me that everyone you talk with in the health field says that that is where the hemorrhage is. That is where we are losing money, that over half of the money is spent on 5 percent of the population, and yet I never see a proposal where people are saying we are going to go directly to where that problem is and stop this hemorrhage.

The last administration said that it was costing us $300 billion a year because of drugs and crime. The criminal justice system lost productivity, lost revenue, just dealing with the problems that we have with drugs, and they never pulled out the health part for me. The last administration I challenged they never really had a drug treatment rehabilitation program, I never heard the former Secretary talk about it, and I will be challenging this administration, to be talking more about how much money we are giving to the

States to deal with drug treatment, but what are we doing? Are we holding them accountable? Is it working?

We need some dollars because if we are going to reduce the deficit, we have to get a handle on health, and just expanding the program doesn't really help if all you are doing is taking care of acute care patients.

Secretary SHALALA. Congressman, as you know, we have, in this proposal, added money for drug treatment, and for prevention. In a number of these areas, we have asked for an increase to expand substance abuse treatment programs.

Mr. RANGEL. Madam Secretary, in the last administration they could not tell me one standard of accountability with any of the State programs that we had. There was no Federal standard as to what drug treatment is and believe me, I have been guilty in demanding more money, and I know that many of the programs merely reduce the addicts' problem, but they leave as addicts or they leave drug free and they come back as addicts, and what do we say? We put in $12 billion, or that's what we used to say, and we are asking for another billion next year. So what I am saying is, I know it is just not treatment, it has to be a comprehensive way that we look at this, but the President has yet to decide who the drug coordinator is going to be, and in the last 12 years we have not had anyone from your Department indicate what our policy is.

What are we going to fund? What are we not going to fund or do we just send the money out to the States and say this is what we are waging a battle against.

Secretary SHALALA. Congressman, I agree with you. As you know, I think we have been both fragmented and unfocused in the Department in relationship to drug treatment. In fact, we are, frankly, all over the place, in both the establishment of standards as well as goals, in what we are trying to accomplish, and what the impact is. Obviously the cost is incalculable in terms of young lives that we could tell you treatment costs.

Mr. RANGEL. No, no, you can calculate it. If every executive director, after they have diagnosed a patient and determined what the reimbursement has to be could just check off, is it drug related, I think we could really get a handle on many diseases. I mean just with emphysema, you say that is smoking, lung cancer. You say it is smoking. They can determine a baby born with crack, hey, that is drug related.

Secretary SHALALA. I think your point is well taken, Congressman.

Mr. RANGEL. Could we get some data on that?

Secretary SHALALA. Yes, sir.

Mr. RANGEL. Thank you so much.

[The following was subsequently received:]

ANNUAL COSTS RELATED TO DRUG ABUSE

A major study of the economic costs to the Nation from alcohol and drug abuse and mental illness was released in 1990 (Dorothy Rice, et al). The study estimates the total cost related to drug abuse at $58.3 billion per year. This estimate includes crime, health, and social welfare costs, law enforcement expenses, unemployment, and decreased productivity on the job. With regard to health-related costs, it is estimated that 28 percent of this amount is for treatment and other health costs.

It should be noted, however, that this estimate does not represent the full economic impact of the drug abuse problem today. The base year of 1985—the most recent year for which reliable data sources are available—was used by the study to estimate the costs of treatment, reduced productivity, mortality, criminal justice expenditures, and other related costs in each problem area. These estimates were then projected to 1988 using inflation indexes and other factors.

Thus, this estimate does not reflect illicit drug abuse that did not lead to the use of the treatment system, work absenteeism, or some other measurable economic loss. Also not included are the financial impact on society from the crack epidemic which hit the United States after the 1985 base year or the costs associated with morbidity and mortality due to HIV/AIDS. One final cautionary note—also not taken into account is the degree of underestimation resulting from underreporting of addictive disorders. Because of stigmatization or negative impact on insurance reimbursement, addictive disorders have been consistently underreported. We do not know the magnitude of the underestimate but believe it to be substantial.

Chairman ROSTENKOWSKI. Mr. Kopetski will inquire.

Mr. KOPETSKI. Thank you, Mr. Chairman. Welcome to the committee. I have a couple of different areas that I would like to question you about. The first one has to do with philosophy. There has been a lot of talk today about different kinds of care for different ages from children to the elderly and long-term care, but what has been omitted, which is usually omitted, is a commitment to mental health care in this Nation, and my question for you is, is the Clinton administration's philosophy as to whether they will treat mental illnesses at the same level and with parity with physical illnesses in any kind of a national health care package?

Secretary SHALALA. Yes.

Mr. KOPETSKI. Wonderful. The second question has to do with a more specific item that, again, has been pioneered by the State of Maryland, and that has to do with electronic benefit transfers of different kinds of social welfare payments so that I don't know if you are familiar with these kinds of 1990s type programs where recipients will be issued essentially a credit card and then their values will be deducted as they use them. This cuts down on sales of coupons for drug purposes. It is a very efficient way of using today's technologies.

We are trying to implement that in Oregon as a pilot program, and I guess the first question is when we see it work in one State, why don't we just send these ideas to the rest of the country? What is stopping us? So many States do do creative things and do get waivers. When we see they work, why don't we go with them nationally?

Secretary SHALALA. I have no excuse for that, Congressman.

Mr. KOPETSKI. So at least for Oregon we can expect some help in terms of getting our State on line from your office?

Secretary SHALALA. Yes, and I have actually been in regular conversations with your Governor.

Mr. KOPETSKI. You are talking about a different one. I have some problems with our waiver program on the medicaid program.

Secretary SHALALA. Your point is well taken that if something works in one part of the country, we obviously ought to either incorporate it as part of national policy if we think that that is what ought to be done, because the States are, in fact, those innovative centers that have taught us a lot about social policies and health policies over the years. Those ideas ought to be incorporated, transferred, and tried out in numerous States. If we try it in one and we want to mount a national demonstration program, and that con-

cept and the change in culture about continuous improvement in terms of social policy and ideas for improving programs, is precisely what we ought to do if we are really going to improve the credibility of government and the delivery systems.

Mr. KOPETSKI. As a final area perhaps, then, I would like to hear your thoughts on what is going to happen. Well, let me just kind of finish up on the danger of the waivers programs. As we have seen in one Western State where they wanted waivers for really punitive reasons to deny people benefits as opposed to granting a waiver to break down some walls so that you can use dollars from different pots of money to help people, the reasoning is very important on this, but as more and more States, whether it is my State or California or other States, are faced with their own budget crises, and as we work through a welfare reform program, we have a State like Oregon that is really one of the leaders in the country, and we modeled our program, interestingly, off of California.

Well, because of the California budget crisis they really weren't able to implement their program as well as we have done. What are we going to do if we design these great programs in terms of the Federal component and yet the States don't have the matching dollars?

Secretary SHALALA. Well, and that, of course, happened in the Family Preservation Act on the Jobs Program in particular. I think that one of the reasons why this country has to face up both in health care reform as well as in welfare reform to doing some systemic changes is because the alternative is sort of government by waiver; that the States desperate both to get some successes, I would argue, as well as to control costs have tried all sorts of schemes. All of that suggests to me that if we really are going to have a national government and a federated system that we need more systemic changes, because when States get out in front like that, it suggests that we need to look nationally, and that is why we are doing health care reform and welfare reform and why we must do it in this generation.

Mr. KOPETSKI. Great. Thank you very much. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman. Madam Secretary, welcome. I am a member of two subcommittees on the Ways and Means Committee. First the Human Resources Subcommittee, which will have jurisdiction over the welfare reform package. I am encouraged to hear your support of our ideas. I also serve on the Health Subcommittee, and I was intrigued to see that one of the first things that this administration proposes to do under the auspices of the stimulus package is to provide 300 million extra dollars for immunization. But let me explore with you some of the details of that because I am also a little concerned.

I hope that what we are talking about here, as relates to immunizations, is not a program that stops only at universal purchase. Let me just quote something from my own local press, the Des Moines Register, that commented on this when the President first made his initiative known to the public. They say the claims that the plan will lead to almost universal immunization because the cost of vaccines no longer would be a prohibitive factor may be too

optimistic. Issues such as educating families about the need for shots on schedule and the problems with accessibility to places where they can be obtained would remain.

I would also go on to cite that the Health and Human Services National Vaccine Advisory Committee points out that one of the four barriers that prevent immunizations from being delivered, one of the principal ones is poor public awareness and lack of public request for the immunizations.

Indeed, there is a study from the Centers for Disease Control that took place in four major inner cities that basically said that 86 percent of the kids that were found to be taken with measles, 86 percent of those kids that were unvaccinated were on AFDC, so there appears to be some kind of parallel between welfare and the lack of immunization.

My question to you is this: Under your HHS factsheet you do itemize what you want the $300 million to go for. In addition to providing the vaccines themselves, you want certain personal expenses, vaccine safety and research, the development of a national tracking system and a community-based outreach and information campaign.

Does that mean, Madam Secretary, that we are going to undertake some kind of a program to condition parental responsibility? The physicians that I have talked with and the care givers who are in the position right now to deliver these vaccines, are saying the major problem is getting the people to bring the kids in for the shots. I would just like to hear your views on parental responsibility as we attempt to implement the stimulus regarding immunizations.

Secretary SHALALA. Congressman, the answer to all those things is just about, yes. I mean, we accept the recommendations of our own panels and of that editorial that the fundamental reason that we do not have widespread immunizations in this country is that we do not have a delivery system that does that and because there has not been parental responsibility. The $300 million is, in fact, to put in place the outreach programs and the longer hours, to beef up the clinics, to help in some cases private physicians get the information to their parents, to have a tracking system so that we follow through from the time a child is born, and to follow up in terms of the additional booster shots that a preschool child needs. In fact, we need to get this system in place, and in many ways rebuild it because we once had a system that was better than the current one with this $300 million. We understand the fundamental criticism of not having that system in place, and that is what these recommendations respond to.

Mr. GRANDY. Good, I am glad to hear you say that. It seems to me that some thought might be given to perhaps conditioning AFDC benefits on getting children immunized and perhaps thinking of that as part of a welfare-to-work proposition as well. I don't know how you feel about that, but I would be interested in hearing whether or not we should try to attempt to condition parental accountability on something like this through our efforts on welfare reform. Do you think that is a workable idea?

Secretary SHALALA. Congressman, I believe, that positive incentives do, in fact, work, and, over the last couple of years the CDC

has funded a grant working with the Department of Agriculture tying the WIC program into immunization, offering parents an additional month of WIC funding if they got their child immunized, and, in fact, that program has been very successful. That suggests that once you get the clinics, the hours, and that you make it clear about parental responsibility that all of these things together and perhaps tied to positive incentives through other Federal programs, including an outreach program to child care centers, that all of these things in combination will have an impact on increasing the immunization rates of preschool children.

What I would not do is tie it to any one thing but to put the entire infrastructure in place because that is what the panels, the primary care physicians, the pediatricians, and the editorial writers have essentially said to us.

Mr. GRANDY. Can we move ahead with that as policy or do we need some kind of multicity demonstration project to see if we need to tie these benefits together and condition them either positively or negatively?

Secretary SHALALA. I think we have had some experience on it. I think that as we do the details of this immunization effort and indicate who is going to lead it for the Department and how are these pieces going to be put together, and as you see our bill come up here and I come back and testify at considerable length specifically on this, I think you will be very satisfied that we both responded to what thoughtful people have said to us, as well as understand the interrelationship between parental responsibility and making sure that access to health care providers is also there.

Mr. GRANDY. Well, I am glad to hear you say that because I am sure we agree that the purpose of this program is universal access and not universal purchase. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. I think we wore them all out, Madam Secretary. You know, I would just like to close with this: This is going to be an unusual situation for all of us. I have been Chairman now for I guess I am in my 13th year. Never under a Democratic administration. It has been our fashion here to listen to the administration make their suggestions and then for us to try to modify them or—and I must say with Dr. Bowen I think that we accomplished a great deal as the Secretary under Ronald Reagan, but here again is a situation where we are going to get a budget resolution, and I think the independence of this committee is well known. We don't mind having the Budget Committee tell us what to do as far as a plug number, but to get specific, I think that that is our job, and we will look for where money should be raised or how we can pattern a program. And why I say this is an unusual situation is because we are going to be looking to you. We are going to, as far as, I think, members on our side of the aisle, and I am sure there will be some in the Minority that will want to fashion something, and we will be looking for the administration's suggestion. So we will depend a great deal on what you are saying.

I just want to caution you to be accurate because we have been around trying to write health legislation for a long period of time, and I think that we have got some very talented staff. I think the membership here is quite alert, and I think that if in the end we can stamp something out that can pass the House of Representa-

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tives, it will be an accomplishment of my legislative career because this is probably, as I told the President and the First Lady, this is probably going to be one of the most tedious, sensitive jobs that has ever been fashioned, so Madam Secretary, good luck to you. I hope that you will find us as pleasant and cooperative in the end as you found us in the beginning.

Secretary SHALALA. Thank you very much.

Chairman ROSTENKOWSKI. Thank you very much for joining us.

Secretary SHALALA. Thank you very much.

Chairman ROSTENKOWSKI. The committee stands adjourned.

[Whereupon, at 4:30 p.m., the committee was adjourned, to reconvene at 10 a.m., Tuesday, March 16, 1993.]

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

TUESDAY, MARCH 16, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order. This week we resumed our series of hearings on the Clinton administration's economic and deficit reduction plan. Last week four of the President's key Cabinet members on economic issues laid out for us the details of the three-part package, economic stimulus, public and private investment and deficit reduction.

Today we continue our examination of the President's plan. We will first hear an assessment of the plan's budget effects from Dr. Robert D. Reischauer, Director of the Congressional Budget Office. Then the committee will begin receiving testimony from interested members of the public.

The CBO, as it does every year, reestimated the President's plan based on information provided by the administration. These reestimates have gotten considerable attention since they were released and much has been made of the fact that CBO's estimates show somewhat smaller deficit reduction than the administration's own estimates. In fact, the revisions that CBO has made to the administration's deficit estimates are smaller than the revisions they had to make to most of the Reagan/Bush deficits.

The CBO has provided objective, reliable economic budget information to this committee and to the whole of Congress for almost two decades. We appreciate CBO's sound analysis and we are eager to hear Dr. Reischauer's testimony.

We are also privileged to have many public witnesses who have requested to testify. I believe it is very important that we hear the American people's view. The taxpayers of this Nation voted for change last November. Their collective voice has been heard. The Clinton administration's plan answers the public's call for economic stimulus and job promotion for long-run economic prosperity and for deficit reduction.

The plan has strong support and, no doubt, has some detractors too. Each should have an opportunity to be heard. We are happy to hear from the many witnesses who are taking time to be with us today. We will begin, as I have stated, with Dr. Reischauer. Mr. Archer, would you like to make an opening statement?

Mr. ARCHER. Mr. Chairman, I just want to welcome Bob to the committee again and compliment him on the great work that he does.

Chairman ROSTENKOWSKI. Again, welcome, Bob. We are happy to have you before the committee again. This is no first opportunity for you. You have been here many, many times, as much as many of us have been here. So, Bob, you may proceed.

STATEMENT OF ROBERT D. REISCHAUER, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. Mr. Chairman and members of the committee, I appreciate the opportunity to discuss the President's economic and budget program with you this morning. With your permission, I will submit my prepared statement for the record, and I will use the next few minutes to summarize CBO's preliminary reestimates of the President's program and CBO's appraisal of its likely impact on the economy and on the distribution of tax burdens.

The Congressional Budget Office estimates that the administration's plan will provide a total of $355 billion in deficit reduction from the CBO baseline over the 1993 to 1998 period. This is a net figure that represents $652 billion in gross reductions achieved through tax increases and spending cuts, partly offset by $297 billion in spending increases and tax cuts. This package is roughly three-quarters of the size of the $482 billion agreement to reduce the deficit that was reached in 1990.

Under the administration's proposals, the 1997 deficit, by our estimates, will be $205 billion, or $117 billion below the $322 billion deficit that would result if current policies continued unchanged. The administration's proposals would slow but not halt the growth of Federal debt relative to the size of the economy.

Under the administration's plan, debt held by the public will rise from the 51 percent of GDP that it reached at the end of 1992 to 58 percent of GDP in 1998. That is about 4 percentage points below the level that it would reach if policies were to continue unchanged through the next five years.

CBO's estimates of the net deficit reduction that would result from the President's proposals over the 1993 to 1998 period are some $61.4 billion below those of the administration. The differences are concentrated in five areas. Let me go through them quickly.

First, the Joint Committee on Taxation's estimates of the administration's revenue proposals are about $28 billion lower than those of the administration, with most of the shortfall occurring in the estimates for the increased tax rates for high income individuals and in the compliance and enforcement measures that the administration is proposing.

Second, CBO has not included in its estimates any savings from the change in debt management policies because the administration has not detailed the specific policy changes that it intends to make. However, I want to point out that it is possible to achieve the $17 billion that the administration has put in its plan through measures such as those that were adopted by the Senate Budget Committee when it put together its budget resolution.

The proposed reductions in Medicare provider reimbursements represent a third area of difference between CBO and the administration. This $5 million difference is largely accounted for by the administration's inadvertent use of different economic assumptions in estimating the effects of these proposals.

A fourth reason why CBO's estimates of the savings from the administration's package are lower than those of the administration is that the administration neglected to take account of the lower contributions to the Federal employee retirement programs that would result from the proposed cuts in civilian and military pay in the Defense Department.

Finally, because CBO's estimates of the savings generated by the administration's proposals are lower than those reported by OMB, CBO's estimate of the resulting reduction in the cost of servicing the Federal debt is also lower by about $5 million over the 6-year period.

Let me say a few words about the structure and composition of this deficit reduction package. Three-quarters of the $355 billion in cumulative deficit reduction contained in the administration's program would stem from increases in revenues and one-quarter from cuts in outlays.

On the spending side, the administration would increase domestic discretionary spending but reduce defense spending and mandatory spending. The spending increases would exceed the cuts through 1995, but the spending reductions would dominate in the years after 1995. In CBO's estimation, the administration's budget exceeds the current limits on discretionary outlays for 1994 to 1995 even if one counts the stimulus package as an emergency and therefore does not tally it against the caps that are set forth in the Budget Enforcement Act.

Within the discretionary spending category, defense budget authority under the President's plan would be reduced in real terms by about 21 percent between 1993 and 1997, but domestic budget authority would grow by about 7 percent in real terms over this period.

Now, let me say a few words about the impact that the administration's budgetary proposals are likely to have on the economy. The task of evaluating the economic impact of the President's proposals is complicated by the recent sharp drop that has occurred in long-term interest rates. The fall in interest rates was probably precipitated at least in part by the administration's proposals and by the apparent determination of the Congress to add to this deficit reduction effort.

But rates fell much sooner than most economists would have expected, so it is probable that other factors have played a role in the reduction in long-term interest rates. Nevertheless, if rates remain at their current levels, economic activity will be given a significant boost this year and next year. In fact, the drop in interest rates should more than offset the short-run contractionary effects of the administration's budget proposals, leaving real GDP at levels little different from those in the CBO baseline forecast, rather than lower those levels, as one might have expected from a policy of fiscal contraction.

In the late 1990s, the payoff from deficit reduction should begin to materialize. It will materialize in the form of a slight increase in the economy's potential—the rate of growth of potential output. By slight, I mean something around one-tenth of a percentage point, maybe as much as two-tenths of a percentage point, but really quite modest.

Any dividend from the administration's investment proposals would probably be quite small and would not appear before the turn of the century. Inflation under the administration's plan is likely to be one-tenth or two-tenths of a percentage point higher during the 3 years in which the energy tax is phased in, but once this tax has been phased in, inflation should return to its baseline rate.

With respect to tax burdens, the administration's proposals would raise total average effective tax rates by 7 percent for families in the top quintile and 3 percent for families in the third and fourth quintiles, while reducing the average effective tax rate by 4 percent for families in the bottom quintile. Families in the top 1 percent would bear more than 55 percent of the burden of the new taxes. The proposal would raise the effective tax rate for these families by almost 20 percent, from about 28 percent under current law to about 33 percent under the proposal.

Let me conclude by noting that the administration's proposals would make a substantial contribution to reducing the deficit and should be applauded for that reason, but they are not sufficient to solve our long-run budget problem. If the goal were to balance the budget by the year 2003, 10 years from now, by enacting another deficit reduction plan in 1996, that plan would have to be about twice as large as the one that the Clinton administration has proposed.

While some people hope that health care reform can further tame the deficit monster and get this problem under control, CBO is skeptical that reforming the health care system can curb government health care spending substantially in this century. Modifications in the President's plan, like those made by the budget committees last week, offer a more promising path to lower deficits in the near term.

That completes my summary statement. I will be happy to answer any questions that Members of the committee might have.

Chairman ROSTENKOWSKI. Thank you very much, Doctor.

[The prepared statement and attachments follow:]

TESTIMONY BY ROBERT D. REISCHAUER
Director
Congressional Budget Office

Mr. Chairman and Members of the Committee, thank you for this opportunity to participate in your hearings on President Clinton's economic and budget program. My testimony will assess the Administration's budget estimates, review the Administration's budget proposals, and consider their likely effects on the shape of the economy and on the distribution of the tax burden.

The Clinton Administration has proposed an ambitious program to encourage economic growth by cutting the budget deficit and increasing government spending that could have long-term payoffs. The Congressional Budget Office (CBO) estimates that the Administration's proposals would reduce the deficit from $308 billion in 1993 to $205 billion in 1997. In contrast, with no change in budgetary policies, the deficit would swell to $322 billion in 1997.

CBO's analysis is based on the proposals and estimates described in the Administration's document *A Vision of Change for America*, which was released on February 17. In early April, the President will present a formal budget containing detailed and revised budget proposals as well as updated budget estimates. Because the April budget is likely to modify or clarify some of the Administration's proposals, CBO's current analysis must be viewed as preliminary.

CBO BUDGET PROJECTIONS

CBO estimates that under current budgetary policies the federal deficit will total $301.6 billion in 1993, $286.7 billion in 1994, and $359.7 billion in 1998 (see Table 1). These baseline projections assume that discretionary spending is held to the limits established by the Budget Enforcement Act (BEA) in 1994 and 1995 and grows at the same pace as inflation after 1995. CBO's current baseline budget projections incorporate minor revisions of those that CBO released in January in *The Economic and Budget Outlook: Fiscal Years 1994-1998.*

In CBO's estimation, the Administration's budgetary proposals would add $6.8 billion to the deficit in 1993 and would reduce the deficit every year thereafter. Compared with the CBO baseline, the Administration's plan would reduce the deficit by $18.6 billion in 1994, $27.4 billion in 1995, and $131.2 billion in 1998.

Although the Administration's policies would, on balance, reduce the deficit, its program includes many proposed spending increases and tax reductions. Most of these programmatic increases are labeled as stimulus or investment proposals in the Administration's February 17 document, but some are included in the category of "nondefense discretionary program savings." During the 1993-1998 period, the Administration's plan provides a total of $355 billion in net deficit reduction from the CBO baseline, representing $652 billion in gross reductions, partly offset by $297 billion in increases. In comparison, the 1990 budget summit agreement provided for $482 billion in net deficit reduction over five years.

Differences Between CBO and Administration Estimates

CBO's estimate of the deficit is lower than the Administration's estimate in 1993, 1997, and 1998, but higher in 1994, 1995, and 1996 (see Table 2). These differences take into account differences in estimates of the budget baseline and the Administration's policy proposals. CBO's estimate of the baseline deficit is lower than that of the Administration in most years, but CBO also projects somewhat smaller savings from the Administration's proposals. Because the

Administration's budget estimates are based on CBO's economic assumptions, all of the differences between the Administration and CBO reflect different methods of estimation.

CBO's baseline estimates differ from those of the Administration in two key respects. First, CBO projects higher tax collections after 1994 than the Administration. Differing interpretations of recent trends in corporate income tax collections explain more than half of this difference. Second, both the amount and timing of spending for deposit insurance remain in doubt. During the 1993-1998 period, CBO projects higher outlays for deposit insurance of $6 billion. CBO is more pessimistic than the Administration about the anticipated outlays for savings and loans but less gloomy about the prospects for the Bank Insurance Fund.

For discretionary spending proposals, CBO has generally incorporated the Administration's requested changes in budget authority, even where a proposal is not clearly specified, but has independently estimated the resulting changes in outlays. For mandatory spending, such as Medicaid or Medicare, CBO has used its own estimates of the specific policy changes proposed by the Administration. In three cases--reforming Federal Housing Administration insurance, reforming power marketing administrations, and changing debt-management policies--the Administration has not yet outlined a specific proposal, and CBO's estimate therefore includes no savings for these items.

Differences in estimates of the Administration's policy proposals are concentrated in five areas. First, the Joint Committee on Taxation's estimates of the Administration's revenue proposals, which are shown in the accompanying tables, are about $5 billion a year less than the Administration's estimates. Lower estimates of the amounts generated by the proposed rate increases for high-income individuals and the compliance and enforcement efforts represent most of this amount.

Second, the Administration's estimates assume savings that grow to almost $5 billion in 1998 from changes in debt-management policies. Because the Administration has not detailed its specific changes in debt-management policies, CBO's estimate does not include budgetary savings from this source. Achieving savings of the magnitude the Administration assumes would require shifting most or all borrowing in long-term bonds and much borrowing in medium-term notes to short-term securities.

Third, CBO's estimates of the savings from the proposed reductions in reimbursement of providers in the Medicare program are below those of the Administration. The differences vary by year but approach $2 billion in 1998. This difference in estimates is largely accounted for by the Administration's inadvertent use of different economic assumptions in estimating the effects of these proposals.

Fourth, the Administration's estimates omit the effect of the proposed reductions in federal civilian and military pay on the level of Defense Department contributions to the federal employee retirement programs. Because the agency's contributions are a set percentage of payroll, a reduction in pay will also shrink the amount of the agency's contributions, which are recorded in the budget as undistributed offsetting receipts. By neglecting to include this loss in receipts, the Administration underestimates the deficit by amounts growing to $2.0 billion by 1998.

Fifth, because CBO's estimate of the savings generated by the Administration's proposals is lower than that reported in *A Vision of Change for America*, CBO's estimate of the resulting reduction in the cost of servicing the federal debt is also lower. By 1998, this difference reaches $2.3 billion.

Other reestimates to outlays are smaller, both individually and in total. CBO estimates that outlays from the stimulus package would be $2.1 billion lower in 1993 than the Administration assumes but higher by an equal amount over the 1994-1998 period. CBO attaches higher savings to the Administration's proposals to replace guaranteed student loans with direct loans, extend customs fees, and auction rights to use the electromagnetic spectrum. CBO has lower savings estimates, however, for the Administration's proposed reforms in uranium enrichment, hardrock mining, farm price supports, Medicaid, and the federal buildings fund.

Alternative Baseline Concepts

The budgetary savings generated by the Administration's proposals can be measured using several alternative budget baselines (see Table 3). CBO's estimates use as their starting point the CBO baseline, which assumes compliance with the discretionary spending caps established by the Budget Enforcement Act of 1990. One alternative is the uncapped baseline, which assumes that discretionary spending in the 1994-1998 period grows at just the rate of inflation. The Administration's February 17 document employs still a third baseline concept, in which nondefense discretionary spending keeps pace with inflation, but defense discretionary spending is held to the levels proposed in the Bush Administration's January 1992 budget request (with various adjustments).

The existence of competing baselines and competing estimates creates considerable confusion. The Administration, for example, states that its policies will reduce the 1997 deficit by $140 billion--the difference between the Administration's baseline of $346 billion and its budget estimate of $206 billion. Using the same baseline concept as the Administration but its own estimating methods, CBO would show a reduction of $122 billion--from $327 billion to $205 billion. Compared with the CBO baseline deficit of $322 billion, however, the Administration's reductions total only $117 billion in 1997. For the 1993-1998 period, CBO would estimate savings of $400 billion using the Administration's baseline concept and $355 billion using the CBO baseline. The differences in the figures arise because some of the Administration's discretionary savings are needed simply to comply with the BEA's spending caps.

THE ADMINISTRATION'S PROPOSALS

Three-quarters of the $355 billion in cumulative deficit reduction contained in the Administration's program would stem from increases in revenues and only one-quarter from cuts in outlays. Extension of expiring tax increases and spending cuts would generate $60 billion of the reduction in the deficit. Continuing various tax credits and other revenue-losing provisions, however, would cost $22 billion. The Administration would increase domestic discretionary spending but reduce defense and mandatory spending. The spending increases would exceed the cuts through 1995, but the spending reductions would dominate in later years.

Revenues

The Administration has proposed some 30 revenue-raising items, as well as a smaller number of tax reductions designed to stimulate investment and reward work (see Table 4). The major revenue raisers are an increase in income tax rates for high-income individuals and large corporations, elimination of the limit on earnings subject to the payroll tax for Hospital Insurance, inclusion in adjusted gross income of 85 percent (instead of 50 percent) of Social Security benefits

above the current income thresholds, and establishment of a broad-based energy tax. The investment proposals include a temporary incremental investment credit, a permanent investment credit for small businesses, extension of the research and experimentation credit and other expiring preferences, and expansion of the earned income credit.

Discretionary Spending

The Budget Enforcement Act established separate dollar limits on defense, international, and domestic discretionary spending for fiscal years 1991, 1992, and 1993. A single overall limit applies to discretionary spending in 1994 and 1995. The Administration has proposed extending the discretionary spending limits through 1998, but it has not yet suggested any specific levels.

In CBO's estimation, the Administration's budget is within or near the current limits on discretionary budget authority for 1994 and 1995 but exceeds the limits on outlays. In 1994, total discretionary outlays exceed the cap by $9.7 billion (see Table 5). Of this amount, $6.4 billion represents the 1994 outlays from the 1993 stimulus package, which the Administration proposes to treat as an emergency requirement. Under the terms of the BEA, the discretionary spending limits are increased to make extra room for emergency appropriations. Even excluding the outlays from the stimulus package, the Administration's request exceeds the 1994 outlay cap by $3.3 billion.

The Administration's proposals exceed the cap on discretionary outlays by an even larger amount in 1995. Leaving out $3.2 billion in outlays from the stimulus package, discretionary outlays breach their limit by $11.6 billion.

Within the discretionary spending category, the Administration proposes continued real reductions in defense and real increases in most areas of domestic spending. Defense discretionary budget authority, which totaled $274 billion in 1993, would drop to $264 billion in 1994 and $249 billion by 1997--a cut of 21 percent in real terms. At the same time, domestic discretionary budget authority would grow from its current level of $209 billion to $262 billion--a real increase of 7 percent.

The Administration proposes to increase real discretionary spending in most domestic functions of the budget. By far the largest increases would go to education and related programs--notably, Head Start; elementary, secondary, and postsecondary education; summer youth employment and training; a new national service program for youth; and a new training program for dislocated workers. Compared with the uncapped CBO baseline, the President's program would add $4.0 billion in budget authority (BA) and $2.5 billion in outlays to the education function in 1994, and $13.4 billion in BA and $12.7 billion in outlays in 1998.

Discretionary health programs would also receive substantial increases in funding above the uncapped baseline--$1.2 billion in BA in 1994 and $6.2 billion in 1998. Additional resources would be focused on research relating to AIDS and women, as well as on prevention of substance abuse. The President also proposes large increases in spending for science (for National Science Foundation research and the National Aeronautics and Space Administration), transportation (for highways and mass-transit grants), and income security (for housing assistance; the Special Supplemental Food Program for Women, Infants, and Children; and low-income home energy assistance).

The Administration's proposed reductions in domestic discretionary spending emphasize across-the-board cuts in a wide range of federal programs. The Administration treats many but not all of these cuts as allowances rather than

assigning them to specific budget functions. Eliminating pay increases for civilian agencies in 1994 and limiting pay increases during the next three years would reduce discretionary outlays by $1.6 billion in 1994 and $3.5 billion in 1998. Eliminating 100,000 federal jobs would save $0.9 billion in 1994 and $1.6 billion in 1998. An additional $0.6 billion in 1994 and $4.2 billion in 1998 would be saved by further "streamlining" of the federal government. Still other unspecified administrative savings would total $0.5 billion in 1994 and $3.5 billion in 1998.

Unlike the proposed changes in revenues and mandatory spending, the Administration's discretionary proposals cannot all be enacted into law this year but will depend on future Congressional action. Extending the limits on discretionary spending would constrain the total amount of appropriations, but annual appropriation bills will determine how the total is allocated among individual programs.

Mandatory Spending

The Medicare program accounts for more than half of the proposed cuts in mandatory spending (see Table 6). Major savings would be achieved by maintaining the ratio of premium charges to benefit payments for Supplementary Medical Insurance at its 1995 level; extending other expiring provisions, including those that make Medicare the secondary payer for certain beneficiaries and curtail payments for hospital capital expenditures and outpatient departments; and reducing hospital reimbursement rates. The Administration would also cut payments for medical education in hospitals, clinical laboratories, and physicians not in primary care.

In three other programs, savings would also arise largely from extending current savings provisions that are scheduled to expire. These items include eliminating the option for a lump-sum payment in Civil Service retirement, extending the limit on pension benefits paid to certain veterans in nursing homes, and continuing Customs Service merchandise and passenger processing fees. Additional savings would be achieved by reducing farm price-support payments, replacing the guaranteed student loan programs with direct federal loans, eliminating personal care as a mandatory benefit and making other reductions in Medicaid, and auctioning future rights to use the electromagnetic spectrum.

Increases in mandatory spending are concentrated in three areas. An extension of emergency unemployment compensation through October 2, 1993, has already cleared the Congress and was signed into law on March 4. The Administration also proposes to increase spending on Food Stamps and to expand the earned income tax credit (EITC) for low-income wage earners; the refundable portion of the EITC appears as an outlay in the budget.

Debt Held by the Public

The Administration's proposals would slow but not halt the growth of federal debt relative to the size of the economy. On its current course, debt held by the public will swell from $3.0 trillion (51 percent of gross domestic product) at the end of 1992 to $4.8 trillion (62 percent of GDP) in 1998. Under the Administration's plan, the debt would reach $4.5 trillion, or 58 percent of GDP, in six years. The Administration's proposal for direct loans to college students would add $54 billion to the debt in 1998 but would be matched by a roughly equal increase in interest-earning assets.

EFFECTS OF THE ADMINISTRATION'S PROGRAM

The Administration's budgetary proposals are intended to spur the growth of the economy and to distribute the tax burden more progressively. How well does it accomplish these two goals?

Macroeconomic Implications

Enacting the Administration's proposals would affect the pattern of economic growth slightly over the next few years and could ultimately raise the level of the economy's potential output. Evaluating the proposals is complicated, however, by the recent sharp drop in long-term interest rates--a drop that largely coincided with the announcement of the policies. Ten-year Treasury note rates have fallen from 6.9 percent in early January to 5.9 percent last week. If rates remain at their current levels--which are about 70 basis points lower than those assumed in the CBO forecast--economic activity will be given a significant boost this year and next.

The fall in interest rates was probably precipitated at least in part by the Administration's proposals, but rates fell much sooner than most economists would have expected. Other factors probably also played a role, especially the weakness of European and Japanese economies and, perhaps, a recognition that the probability of a sharp increase in inflation is low. As long as the budget package, when it is passed, sets the budget on a course toward substantially lower deficits, interest rates are likely to remain below those in the CBO forecast.

The combination of the Administration's proposals and the drop in interest rates produces a more favorable outlook than do the proposals alone. Whereas deficit reduction would dampen growth relative to CBO's economic forecast during 1994, the lower interest rates could more than offset that effect. The Administration's proposals also need not cause gross domestic product to fall below the CBO baseline after 1994. Given the steady pattern of the proposed reduction of the deficit, the amount of time people will have to adjust to the budgetary changes, the possibility of even lower long-term interest rates, and the likelihood that monetary policy could offset the fiscal restraint, the level of economic activity in the mid-1990s is likely to differ little from CBO's baseline assumptions.

The payoff for the deficit reduction--an increase in the economy's level of potential output--would start to be realized in the late 1990s. Potential output would increase primarily because the reduction in the federal deficit would increase the net national saving rate. The Administration's proposals for additional investment spending are unlikely to provide a significant boost to potential output during this decade, though of course they may help in subsequent years or may generate benefits other than their impact on potential output.

The Administration's proposed energy tax is likely to raise inflation for a few years, but only slightly. The tax is phased in over three years, beginning in July 1994. Inflation is likely to be 0.1 or 0.2 percentage points higher for those years and then return to its baseline rate.

Redistributing the Tax Burden

The Administration's proposals would shift a greater share of the federal tax burden to high-income taxpayers. CBO estimates that the tax proposals would raise total average effective tax rates by 7 percent for families in the top quintile of the income distribution and 3 percent for families in the third and fourth

quintiles. Expanding the earned income tax credit would reduce the average effective tax rate by 4 percent for families in the bottom quintile (see Table 7).

Within the top quintile, the increase in taxes would be largest for the families with the highest incomes. Families in the top 1 percent would bear more than 55 percent of the burden of the new taxes. The proposal would raise the effective tax rate for these families by almost 20 percent--from about 28 percent under current law to about 33 percent under the proposal.

The quintile rankings array families by adjusted family income, a measure that adjusts family income by a measure of need based on family size. The results are similar when families are ranked by dollar income, except in the lowest income groups. The differences highlight the fact that the tax proposals do not have a uniform effect on all families with the same income. For example, the Administration's program substantially reduces the average effective tax rate of low-income families with children, who will benefit most from expansion of the EITC, but increases taxes on low-income childless families.

To compensate low-income families for the effects of the proposed energy tax, the Administration has proposed increases in Food Stamps and the Low Income Home Energy Assistance Program (LIHEAP). Including these two programs in the calculations would further reduce the estimated burden of the Administration's program on those in the lower half of the income distribution. For the groups with incomes below $30,000, the increase in Food Stamp and LIHEAP benefits would be as large as or larger than the increase in taxes.

CONCLUSIONS

The proposals outlined in *A Vision of Change for America* would make a substantial contribution to reducing the deficit, but they are not sufficient to solve the long-run problem. Both CBO and the Administration estimate that, under the President's policies, the deficit would decline only through 1997 and then resume its rise. By the Administration's own projections, the deficit would reach about $400 billion, or 4 percent of GDP, by 2003.

The Administration pins its hopes for further deficit reduction on its health reform proposals, which are scheduled for release in early May. CBO has frequently pointed out, however, that reforming the health care system is unlikely to curb government spending quickly. In the short run--say, over the next 10 years--it will be exceedingly difficult to realize significant budgetary savings as long as any reform proposal extends coverage to the uninsured, avoids shifting costs to private payers, and maintains many of the desirable aspects of the current system.

A more promising path to still lower deficits would be to make further reductions in programs or to scale back the proposed increases in the President's budget plan, as both the House and Senate Committees on the Budget have done.

TABLE 1. CBO ESTIMATES OF THE ADMINISTRATION'S POLICY PROPOSALS
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Baseline Deficit[a]	301.6	286.7	284.4	290.0	321.7	359.7
Deficit Reductions						
Outlays						
Discretionary spending	0	-3.4	-7.7	-28.4	-56.2	-63.4
Mandatory spending	0	-4.2	-7.5	-17.8	-25.0	-30.8
Debt service	0	-1.6	-5.2	-11.1	-20.4	-32.2
Subtotal, outlays	0	-9.1	-20.5	-57.2	-101.6	-126.4
Revenues[b]	0	-45.8	-52.4	-68.1	-84.8	-86.0
Total, Reductions	0	-55.0	-72.8	-125.3	-186.4	-212.4
Deficit Increases						
Outlays						
Discretionary spending	3.3	13.0	22.6	31.8	39.4	44.5
Mandatory spending	3.3	3.8	5.9	7.0	7.1	7.3
Debt service	0.1	1.4	3.7	6.8	10.6	15.1
Subtotal, outlays	6.8	18.2	32.1	45.5	57.1	66.9
Revenues[b]	0	18.2	13.3	11.7	12.6	14.3
Total, Increases	6.8	36.3	45.4	57.2	69.6	81.2
Total Changes	6.8	-18.6	-27.4	-68.1	-116.7	-131.2
Deficit Under the President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Assumes compliance with the discretionary spending limits in the Budget Enforcement Act through 1995; discretionary outlays are assumed to grow at the same pace as inflation after 1995.

b. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

TABLE 2. DIFFERENCES BETWEEN CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S PROPOSED BUDGET (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Administration's Estimate of the Deficit	331.4	262.4	241.6	205.3	206.4	241.4
CBO Reestimates of the Administration's Baseline						
Revenues[a]	4.9	b	-6.2	-5.7	-16.0	-27.7
Deposit insurance	-13.9	-3.4	13.6	12.9	-1.5	-1.5
Other outlays	-8.5	-1.8	-1.6	-3.5	-1.5	b
Subtotal	-17.4	-5.2	5.8	3.8	-19.0	-29.2
CBO Reestimates of the Administration's Proposals						
Revenues[a]	-3.6	8.8	4.3	5.7	6.6	5.7
Debt management	0.2	1.6	2.7	3.3	3.9	4.9
Medicare	0	0.6	0.9	0.4	1.3	1.8
Pay offsets	0	0.6	1.0	1.4	1.7	2.0
Debt service	-0.2	-0.1	0.4	0.9	1.6	2.3
Other outlays	-2.0	-0.7	0.2	1.3	2.5	-0.5
Subtotal	-5.6	10.9	9.5	12.9	17.5	16.2
Total Reestimates	-23.1	5.7	15.4	16.7	-1.5	-12.9
Deficit Under the President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17, 1993. In early April, the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

b. Less than $50 million.

TABLE 3. CBO AND OMB ESTIMATES OF BASELINE DEFICITS
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Estimates						
Uncapped Baseline Deficit	301.6	301.5	312.1	318.5	351.0	390.8
Reductions						
Bush Administration's defense proposals[a]	0.2	-5.2	-9.8	-16.3	-21.1	-26.0
Debt-service savings	b	-0.1	-0.6	-1.4	-2.7	-4.3
Subtotal	0.2	-5.4	-10.4	-17.7	-23.7	-30.3
Administration Baseline Deficit	301.8	296.1	301.8	300.8	327.3	360.6
Further Reductions Required to Meet Discretionary Caps						
Discretionary spending	-0.2	-9.2	-16.4	-8.9	-3.2	1.7
Debt-service savings	b	-0.3	-1.0	-1.9	-2.4	-2.6
Subtotal	-0.2	-9.4	-17.4	-10.7	-5.6	-0.9
Capped Baseline Deficit[c]	301.6	286.7	284.4	290.0	321.7	359.7
OMB Estimates						
Uncapped Baseline Deficit	319.2	306.7	306.0	313.6	368.8	418.6
Reductions						
Bush Administration's defense proposals[a]	0	-5.3	-9.5	-15.2	-20.0	-24.8
Debt-service savings	0	-0.2	-0.6	-1.4	-2.6	-4.1
Subtotal	0	-5.4	-10.1	-16.6	-22.5	-28.9
Administration Baseline Deficit	319.2	301.3	295.9	297.0	346.3	389.7

SOURCES: Congressional Budget Office; Office of Management and Budget.

a. Includes adjustments to the Bush Administration's request as estimated by the Clinton Administration.

b. Less than $50 million.

c. Assumes compliance with the discretionary spending limits in the Budget Enforcement Act through 1995; discretionary outlays are assumed to grow at the same pace as inflation after 1995.

TABLE 4. JCT/CBO ESTIMATES OF CLINTON ADMINISTRATION REVENUE PROPOSALS (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998
Stimulus and Investment Proposals					
Investment Credits and AMT Depreciation	-13.4	-7.1	-4.2	-3.8	-4.2
Enterprise Zones	-0.2	-0.7	-1.1	-1.6	-2.1
Expand EITC[a]	-0.2	-1.9	-2.0	-2.1	-2.2
Exclude Capital Gains on Original-Issue Small Business Stock	-0.0	-0.1	-0.2	-0.2	-0.2
Extend Preferences	-4.1	-3.3	-4.1	-5.0	-5.8
All Other	-0.2	-0.3	0	0.1	0.2
Total, stimulus and investment proposals	-18.2	-13.3	-11.7	-12.6	-14.3
Revenue-Raising Proposals					
Increase Top Individual Tax Rate to 36%; 26% and 28% AMT; Increase AMT Exemption to $45,000/$33,750; 39.6% Rate on Taxable Income Greater than $250,000; Extend Phaseout of Personal Exemptions and Limit on Itemized Deductions	25.7	17.0	19.9	24.0	25.8
Remove Cap on HI Taxable Wage Base[b]	2.8	6.0	6.4	6.8	7.2
Include 85% of Social Security Benefits in AGI	2.9	6.1	6.9	7.7	8.5
Increase Income Tax Rate on Corporations	8.1	5.4	5.7	5.9	6.1
Establish Broad-Based Energy Tax[b]	1.0	9.4	17.0	22.1	23.5
Extend 2.5 Cents per Gallon Gas Tax[b]	0	0	2.6	2.7	2.7
Cap Possessions Tax Credit (Sec. 936) at 65% of Wages	0.2	0.8	1.9	2.7	2.7
Restrict Deduction for Business Meals and Entertainment to 50%	1.8	3.2	3.3	3.5	3.6
International Tax Provisions	0.4	1.1	1.0	1.0	1.1
Compliance Provisions	0.1	0.2	0.2	0.2	0.2
Change Corporate Estimated Tax Rules	0	0	0	4.3	0.9
All Other	2.9	3.2	3.1	3.8	3.9
Total, revenue-raising proposals	45.8	52.4	68.1	84.8	86.0
All Proposals					
Total	27.7	39.1	56.4	72.2	71.7

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: JCT = Joint Committee on Taxation; AMT = alternative minimum tax; EITC = earned income tax credit; HI = Hospital Insurance; AGI = adjusted gross income.

a. Two-thirds of the effect of expanding the EITC is in the form of refundable tax credits. The refundable portion is not included here. It is included with the outlay proposals.

b. Net of income tax offsets.

TABLE 5. THE ADMINISTRATION'S PROPOSALS FOR DISCRETIONARY SPENDING IN FISCAL YEAR 1994 (In billions of dollars)

Category	CBO Baseline Without Discretionary Caps		President's Budget as Estimated by CBO		Difference	
	Budget Authority	Outlays	Budget Authority	Outlays	Budget Authority	Outlays
Defense	288.0	289.6	264.0	277.8	-24.0	-11.8
International	21.9	21.8	21.9	21.9	-0.1	0.2
Domestic						
General science, space, and technology	17.7	17.5	19.0	18.3	1.3	0.8
Energy	6.1	5.9	5.8	5.7	-0.4	-0.2
Natural resources and environment	22.3	21.9	21.7	22.6	-0.6	0.8
Agriculture	4.5	4.4	4.2	4.3	-0.3	-0.1
Commerce and housing credit	3.6	3.5	3.7	3.7	0.1	0.2
Transportation	14.4	36.5	14.8	39.2	0.4	2.8
Community and regional development	8.0	8.3	8.5	9.5	0.5	1.3
Education, training, employment, and social services	38.2	37.5	42.2	40.0	4.0	2.5
Health	21.3	20.9	22.5	21.6	1.2	0.7
Medicare	3.0	3.0	3.0	3.0	a	a
Income security	32.0	34.8	32.0	35.4	a	0.6
Social Security	0	2.8	0	3.0	0	0.2
Veterans' benefits	17.5	17.4	17.5	17.6	a	0.2
Administration of justice	14.9	15.0	15.2	15.3	0.3	0.3
General government	12.5	12.6	12.7	12.9	0.2	0.3
Allowances	0	0	-3.9	-3.4	-3.9	-3.4
Subtotal, domestic	215.9	242.0	218.9	248.8	3.0	6.9
Total, Discretionary Spending	525.8	553.3	504.8	548.6	-21.1	-4.7
Discretionary Caps[b]	513.2	538.9	513.2	538.9	n.a.	n.a.
Difference	12.7	14.4	-8.4	9.7	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a.. = not applicable.

a. Less than $50 million.

b. End-of-session limits as estimated by CBO.

TABLE 6. THE ADMINISTRATION'S PROPOSALS FOR MANDATORY SPENDING
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Reductions						
Medicare premiums	0	0	0	-1.3	-3.2	-5.1
Extend other expiring						
Medicare provisions	0	a	a	-2.0	-2.6	-3.0
Reduce hospital reimbursement	0	-1.1	-1.8	-2.1	-2.3	-2.5
Other Medicare savings	0	-1.4	-2.5	-4.2	-5.9	-7.2
Subtotal, Medicare	0	-2.5	-4.3	-9.6	-14.0	-17.9
Farm price supports	0	-0.1	-0.2	-0.8	-1.6	-1.8
Student loans	0	0.1	0.1	-1.1	-2.6	-3.1
Medicaid	0	-0.2	-1.4	-1.8	-2.1	-2.4
Civil Service retirement	0	a	-0.1	-2.2	-3.3	-3.6
Veterans benefits	0	-0.3	-0.4	-0.4	-0.4	-1.2
Customs user fee	0	0	0	-0.8	-0.8	-0.9
Spectrum auctions	0	-1.7	-1.8	-1.7	-1.0	-1.0
Pay offsets	0	1.0	1.4	1.8	2.3	2.8
Other	0	-0.5	-0.9	-1.3	-1.4	-1.8
Total, Reductions	0	-4.2	-7.5	-17.8	-25.0	-30.8
Increases						
Unemployment compensation	3.3	2.3	0	0	0	0
Food Stamps	0	1.0	2.0	3.0	3.0	3.0
Earned income tax credit	0	0.4	3.8	4.0	4.1	4.3
Other	0	0.1	0.1	a	a	a
Total, Increases	3.3	3.8	5.9	7.0	7.1	7.3
Total	3.3	-0.4	-1.7	-10.8	-17.9	-23.5

SOURCE: Congressional Budget Office.

a. Less than $50 million.

TABLE 7. CHANGES IN EFFECTIVE TAX RATES BY INCOME GROUP FROM THE PRESIDENT'S TAX PROPOSALS (In percent)

	Effective Tax Rates		Percentage Change in		Share
	Current Law[a]	Proposal	Effective Tax Rate	After-Tax Income	of Change in Taxes
Families by Adjusted Family Income					
Income Quintile					
Lowest	7.0	6.7	-4.3	+0.3	-0.9
Second	15.0	15.2	+1.1	-0.2	1.4
Third	19.3	19.8	+2.7	-0.7	6.6
Fourth	22.1	22.6	+2.6	-0.7	10.8
Highest	26.2	28.1	+7.1	-2.5	81.3
All	22.8	24.0	+5.1	-1.5	100.0
Detail on Highest Quintile					
81-90 Percent	24.6	25.2	+2.6	-0.8	8.4
90-95 Percent	25.9	26.5	+2.5	-0.9	5.6
96-99 Percent	26.8	27.8	+3.6	-1.3	10.8
Top 1 Percent	28.0	33.2	+18.7	-7.3	56.5
Families by Dollar Income (In thousands)					
Income Level					
Less than 10	7.5	8.0	+6.7	-0.5	0.8
10 to 20	11.5	11.8	+2.9	-0.4	1.7
20 to 30	16.9	17.0	+0.4	-0.1	0.5
30 to 40	19.8	20.2	+2.3	-0.6	3.8
40 to 50	21.6	22.2	+2.9	-0.8	5.4
50 to 75	23.4	24.1	+2.7	-0.8	11.6
75 to 100	25.2	25.8	+2.4	-0.8	6.8
100 to 200	26.1	26.8	+2.4	-0.9	8.2
200 or more	27.9	32.7	+17.6	-6.8	60.3
All	22.8	24.0	+5.1	-1.5	100.0

SOURCE: Congressional Budget Office.

NOTES: The estimates assume 1998 tax law and 1994 income levels. They include all tax proposals except the enterprise zone proposal, the proposal on corporate estimated tax payments, and miscellaneous compliance measures.

Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, and all cash transfer payments. Income also includes the employer's share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by adjusted family income, income for each family is divided by the projected 1994 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Individuals are treated as families of one. Families with zero or negative income are excluded from the lowest income category but included in the total.

Changes in individual income taxes, premiums, and entitlements are distributed directly to families paying those taxes and premiums, or receiving those benefits. Changes in payroll taxes are distributed to families paying those taxes directly, or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed good or service. Changes in corporate income taxes are distributed to families according to their income from capital.

a. Current law reflects the scheduled expiration of the limitation of itemized deductions, the phase-out of personal exemptions, and the 2.5 cent component of the gasoline tax that goes into the general fund.

Chairman ROSTENKOWSKI. Dr. Reischauer, on tax reform, the act of 1986 attempted to reduce economic distortions and to limit tax sheltering opportunities. What, in your opinion, will be the impact of the administration's package on the accomplishments of the act of 1986?

Mr. REISCHAUER. What will the impact be of the Clinton administration's proposals?

Chairman ROSTENKOWSKI. What will be the impact of the administration's tax proposals on the 1986 act?

Mr. REISCHAUER. Well——

Chairman ROSTENKOWSKI. What I am referring to, naturally, is that in this room we worked for almost 18 months trying to narrow down the code to where we were eliminating loopholes for tax dodgers. I would just like to know your opinion.

Mr. REISCHAUER. I think it represents a slight turn away from the principle that governed the 1986 tax reform initiative, the idea of broad base and low rates. Various aspects of the administration's proposal obviously provide certain preferences that have not existed for the last 7 years, as well as greater rate differentials and this is a step away from that principle. But I don't think we should exaggerate the size of that step.

The problem is that once you have higher rates, even rates that are still substantially below those that existed in 1986, you will be under increased pressure to provide relief in the form of exceptions and preferences.

Chairman ROSTENKOWSKI. Your office, Doctor, has done an additional analysis of the administration's energy tax. Tell me, how will the broad-based energy tax that the administration is proposing affect different regions of the country? Isn't the administration's version of the energy tax more neutral across regions of the country than other versions of an energy tax would be?

Mr. REISCHAUER. When you compare the administration's proposal with oil import fees or higher gasoline taxes, I think that is certainly true. The Btu tax that the administration has suggested would have more neutral consequences on a regional basis, although there is some differential. We have not examined the full range of that differential at this point.

Chairman ROSTENKOWSKI. One of the investment tax incentives in the President's plan would provide a 2-year temporary incremental investment tax credit. I have heard from several taxpayers that mature industries that have institutionalized long-term investment strategies would not benefit from this rule. Can you give us an idea of how limited this proposal is?

In addition, given our past experience with temporary incentives, what economic effect is such a temporary stimulus likely to have?

Mr. REISCHAUER. With respect to the first part of your question, certainly large corporations that are considering big capital investments are not going to be swayed by a temporary tax credit of the size being proposed.

However, even those large, mature industries do have some discretion with respect to their investment strategies, and I believe they would respond around the edges. But by and large, what we will see is a shifting of investment; investment that would have occurred several years from now will be pulled forward. So much of

the gain that is received over the course of the next two years will appear as reduced investment and reduced economic activity in the future.

Of course, this proposal is being made to stimulate the economy more than to increase the level of investment in the economy in the long run.

Chairman ROSTENKOWSKI. You know, Bob, I have never seen a so-called limited incentive that in the first 6 months of its adoption there isn't a suggestion that we extend the incentive. How does this stimulus affect our international competitiveness? Is there going to be on the part of larger corporations so-called keener competition by foreign investment coming in, taking advantage of this incremental stimulus and making them, in fact, in the long run less competitive internationally? Because you are going to see foreign money come in, aren't you?

Mr. REISCHAUER. I think the degree of that shouldn't be exaggerated. A temporary investment tax credit has a certain degree of inequity to it because it appears at a certain time in our history, and some firms have just made large investments, maybe existing firms in the United States, while new firms that possibly are setting themselves up with foreign capital could take full advantage of this. There may be some inequity created by that, but that is always the case with temporary measures of one sort or another.

With respect to your first concern, which is whether anything is ever really temporary, I think there is a better chance that this stimulus would be temporary, simply because we are still under the pay-as-you-go rules established by the Budget Enforcement Act. Those rules, according to the President, will be extended to the year 2003, and that means that any time you provide a benefit that costs money or reduces taxes, it has to be paid for in some way. So there is some brake on the system now that did not exist before 1990.

Chairman ROSTENKOWSKI. Thanks, Bob.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman. Dr. Reischauer, are you familiar with the National Center for Policy Analysis?

Mr. REISCHAUER. I know of it, yes, and I receive their publications in the mail and read them.

Mr. ARCHER. I am going to inquire for a few minutes as to their analysis compared to your analysis and see if we can reach some sort of understanding as to the differences.

Mr. REISCHAUER. I have not read their analysis of the——

Mr. ARCHER. This is just a preliminary analysis as I understand and I know you don't have a copy of it. I am going to read a couple of things to you and then ask you a question or two. The 1990 budget agreement with which you worked in great detail over many, many hours promised spending cuts in the later years in exchange for tax increases up front. That is a generalization, but I think it is a fair generalization.

However, President Clinton has already exercised his option under that agreement to suspend the enforcement mechanisms for 1994 and 1995 and I suppose, by implication, for all future years as well. Now, the National Center for Policy Analysis says that his refusal to force spending cuts under the current budget rules of

OBRA, that was the 1990 Budget Act, has the effect of increasing the Federal deficit by $251 billion through 1998 and $461 billion through the year 2000.

Does that pretty much correspond to your estimate of that particular action on the part of the President?

Mr. REISCHAUER. I think what you are referring to is the President's decision to adjust the maximum deficit amounts through 1995 for changes that occur because of economic and technical factors. This aspect of the law was required for the Bush administration through 1993. It had to adjust the maximum deficit amounts and then the law gave the President who came into office on January 20 the option of continuing the previous policy of an automatic adjustment.

Mr. ARCHER. So-called spending caps, right?

Mr. REISCHAUER. No, it wasn't spending caps. It was that the Budget Enforcement Act left in place the structure that was established by the Gramm-Rudman-Hollings procedure—that is, that we would have a maximum deficit amount, and if the maximum deficit amount was exceeded, there would be an automatic sequestration. But during the first 3 years, this maximum deficit amount was automatically adjusted up or down if the economy changed or if certain technical factors caused the estimate of the deficit to rise or fall.

So if you stuck with the pay-as-you-go system and the discretionary spending caps that were established by the Budget Enforcement Act, it was impossible to trigger this Gramm-Rudman-Hollings-type sequestration. Once the 1993 budget decisions were over, we had the option of continuing that automatic adjustment process or not continuing it. If one did not continue it, it was possible for the Congress to maintain the pay-as-you-go discipline and to stay within the caps and still be faced with a Gramm-Rudman-Hollings-type sequestration.

Our estimates were that for fiscal year 1994, I believe, even if the President had chosen not to continue the policy of making the economic and technical adjustments, there would not have been a sequestration. I have not looked at this study, as I said, but I think it might not——

Mr. ARCHER. I thank you for that analysis, but does it sound reasonable to you that that action on his part affected the deficit by $251 billion through 1998?

Mr. REISCHAUER. No, it doesn't. I mean, it seems——

Mr. ARCHER. I would be very interested.

Mr. REISCHAUER. We will look into this study and——

Mr. ARCHER. I would like for you to and if you can, submit to the committee in writing the rationale as to the differences.

Mr. REISCHAUER. Let's suppose that those numbers are correct. What they would be saying is that, to avoid a sequestration, the Congress would have to come back with a set of policy measures that would reduce the deficit by that amount. I have just said in my testimony that the President has produced a package that would reduce the deficit between now and 1998 by a total of $355 billion, so in a sense, his package will bring the deficit down.

Mr. ARCHER. But, Bob, you also said that in the first year that it increases the deficit. We are talking about the years 1994 and

1995. His so-called deficit reduction package will not reduce the deficit during 1995, those two years on accumulative basis; is that not correct?

Mr. REISCHAUER. I believe he is increasing the deficit in 1993.

Mr. ARCHER. Your figures were 1994 increasing the deficits——

Mr. REISCHAUER. And then decreasing——

Mr. ARCHER [continuing]. By $6 billion in 1994, so the removal of the enforcement mechanism for 1994 has got to significantly impact what your original projections were as to the deficit when we passed the 1990 budget agreement; is that not correct?

Mr. REISCHAUER. Yes, that is true, and when I gave that $355 billion number, I was adding in the increase in the short run that would occur in the deficit and balancing that against the future decreases.

Mr. ARCHER. But clearly—what were your projections? The 1990 act, traumatic as it was, provided major spending reductions in the last 2 years. As I recall, the CBO projections in 1990 were that that agreement was going to reduce the deficit by close to $500 billion over 5 years; is that not correct?

Mr. REISCHAUER. That is correct.

Mr. ARCHER. What has actually happened?

Mr. REISCHAUER. Well, of course, we have only gone through the first 2½ years of these savings, but our feeling is that we are pretty much on track. The deficit is not lower than it was or than it was projected to be, but had the 1990 agreement not been adopted, the deficit would have been some $33 billion higher in 1991, $69 billion higher in 1992, and abstracting from the Clinton administration's proposals, roughly $90 billion higher in 1993 than it would be without those measures.

The Congress has held down discretionary spending, and the various measures that were taken to reduce mandatory spending and to increase tax revenues are generating savings.

Mr. ARCHER. Well, I would like to pursue that at length some other time but I am afraid we don't have the time this morning to do it. National Center for Policy Analysis says that the net cumulative Federal deficit will increase by $155 billion through the end of the decade as a result of what the Clinton administration program would involve, all of the aspects of it, including the stimulus, the so-called deficit reduction; the combination of everything will actually increase the deficit by $155 billion through the end of the decade.

Now, you haven't seen the background, but I would be interested for submission to the committee, if you will, of the difference in their analysis and your analysis. They also say that the announced goal of the Clinton plan is to increase the economic well-being of middle-income families, but that because the plan would cause lower economic growth, the average family would be worse off.

The Clinton plan will cause annual gross domestic product to be $261 billion lower than it would otherwise have been in 1998. Average gross domestic product would be $261 billion lower than it would otherwise have been in 1998. The economic loss from that is equal to more than $1,000 per man, woman and child in the country or more than $2,600 for an average household.

The Clinton plan will cause wage income in the United States to be $160 billion lower than it would otherwise have been in 1998. Now, I am hitting you with these figures and you haven't looked at the study but the figures stand out in pretty stark reality. I would like to know what your projections are on those same figures.

Chairman ROSTENKOWSKI. Would you submit those for the record?

Mr. REISCHAUER. Yes, I will be glad to.

[CBO submitted the following:]

The National Center for Policy Analysis maintains that the Administration's proposals will severely discourage investment, lower the level of output, and significantly worsen the economic situation of the average family in 1998. Although some aspects of the proposals could discourage private saving and investment, analysis by the Congressional Budget Office (CBO) indicates that the proposals' net effect on national saving and investment will eventually be positive. By 1998, both investment and saving will be a higher share of gross domestic product (GDP) than in the CBO baseline forecast, which assumes that future deficits are constrained by the discretionary spending limits and pay-as-you-go requirement of the Budget Enforcement Act. The proposals are likely to have a small adverse effect on the level of GDP and family well-being in 1998, but in the long run GDP will be higher and families will be better off.

CBO's analysis of the effects of deficit reduction on the economy is discussed in Chapter 5 of The Economic and Budget Outlook: Fiscal Years 1994-1998 (January 1993). Because CBO estimates that the Administration's proposals will result in lower deficits than the baseline, national saving and investment rates will eventually be higher and real interest rates will be lower, as described in the Outlook.

Some of the benefits of deficit reduction may be offset by other elements of the Administration's plan. In particular, increasing the taxation of high-income individuals may reduce the personal saving rate more than other methods of deficit reduction would. CBO does not believe that the disincentives to saving, however, will be large relative to the direct improvement in national saving that results from deficit reduction.

Deficit reduction tends to suppress economic growth in the near term, but because of the recent fall in long-term interest rates and the possibility that monetary policy could offset the dampening effects of deficit reduction, it is reasonable to forecast that the level of GDP in 1998 will be only slightly below the baseline. This result is discussed in both the Outlook and CBO's March 1993 report, An Analysis of the President's February Budgetary Proposals. For three reasons, consumption per person would also be slightly lower. Because deficit reduction encourages investment to rise as a share of GDP, consumption would be a smaller share of GDP. In addition, the higher income tax rates and the energy tax would lower household after-tax income for any given level of GDP. Lastly, the overall level of GDP would be lower. None of these effects is likely to be large, however, and in the long run, the increased share of investment would result in a higher level of both GDP and family well-being.

The National Center for Policy Analysis also contends that "Clinton's refusal to force spending cuts under the current budget rules (OBRA) has the effect of increasing the cumulative federal deficit by $251 billion through 1998." By CBO's estimation, if President Clinton had chosen not to adjust the maximum deficit amounts for fiscal years 1994 and 1995, the amount of additional deficit reduction required would have been $17 billion in 1994 and $29 billion in 1995. The size of the effect in later years would depend on the policies chosen to implement the reductions, but it would be unlikely to total as much as $251 billion. In comparison, President Clinton's budgetary proposals would reduce the deficit by $19 billion in 1994, $27 billion in 1995, and $355 billion over the 1993-1998 period.

Mr. ARCHER. Let me ask you two other quick questions. Did you include the energy cost to the Federal Government in your cost estimates, that is the increased energy costs from the energy tax to the Federal Government on the spending side of the Federal ledger?

Mr. REISCHAUER. No, we don't, because energy expenditures are discretionary expenditures. Since you have placed caps on total discretionary spending, the Federal agencies have to eat that increase somehow through producing some other kinds of savings.

Mr. ARCHER. Aren't those caps gone now for the future?

Mr. REISCHAUER. No, they will continue through 1995. The President has indicated that he would like them extended through 1998, but as of now, I don't think there is an agreement on exactly what level those caps will be set.

Mr. ARCHER. So until you know at what level those caps are set, you can't determine for sure whether or not these higher energy costs of the Federal Government, which are clearly going to have to be paid in the purchase of energy, need to be considered on the spending side; is that accurate?

Mr. REISCHAUER. That is correct. But I think you will be setting those caps based on more global considerations.

Mr. ARCHER. Mr. Chairman, I have one last very important question I would like to ask Dr. Reischauer. Have you taken into account, relative to the increased taxes on higher income people, behavioral response? By that I mean where there is flexibility with higher income and you are raising the top maximum marginal rate to close to 44 percent effectively, many of those higher income people are going to decide to go into tax-exempt municipal bonds, to go into capital items for tax-deferred capital gain, and to go into stock options instead of salary increases. Have you taken that behavioral response into account in determining what the revenue estimates for tax revenue under the program will be?

Mr. REISCHAUER. Under law, the revenue estimates that we use for estimating proposals like these are provided to us by the Joint Committee on Taxation. It is my understanding that the Joint Committee on Taxation, as well as the Treasury Department, does take those sorts of behavioral responses into account. I don't know the details of their adjustments, however.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Andrews will inquire.

Mr. ANDREWS. Thank you, Mr. Chairman. Let me just ask you in general, Mr. Reischauer, as I understand it, is it your view, indeed CBO's view, that this deficit package is a contribution to deficit reduction? And that this is a positive step that the Congress is being asked to take by the President?

Mr. REISCHAUER. Very definitely. You can argue about the composition of it, but we as an agency have been at the forefront of arguing that deficit reduction is extremely important.

Mr. ANDREWS. How one goes about it is of secondary importance. The important thing is to adopt some sort of policies that will reduce the deficit and reduce it now. My friend, Mr. Archer, suggested that in spite of what the President is recommending, the deficit is going to increase in the out-years. Wouldn't that happen

just about whoever is President right now today because of health care costs?

Mr. REISCHAUER. Well, if nothing is done, the deficit is going to increase very substantially. Our estimates would suggest that by the year 2003 it will be $653 billion. I would be very skeptical about estimates that suggest that the President's package will not lead to a lower deficit. The only way one can get to that, I think, is to argue that the economy will be thrown into the tank by too energetic a series of measures that raise taxes and cut spending.

However, as I tried to imply in my oral statement, the drop that we have seen in interest rates over the last several months, if one thinks that is associated in some way with this new resolve of our political leaders to reduce the deficit and one attributes that to the Clinton plan, suggests that the economy won't be significantly affected.

In fact, it will perk along at about the rate CBO has suggested would occur in the absence of deficit reduction. This is, I think, quite good news for policymakers and suggests that there won't be large income losses by American middle-class families.

Mr. ANDREWS. But the big bear out there that is waiting to be dealt with is health care, isn't it? I mean, the danger here is that if we fail to deal with health care then we lose whatever initiative we might gain by this package?

Mr. REISCHAUER. All of the deterioration in the deficit after the mid-1990s in our baseline forecast comes from the continued explosion of Medicare and Medicaid costs.

Mr. ANDREWS. Now, just in another section, and that is investment, Mr. Archer mentioned investment and how important that is and how this package may change investment decisions. I don't doubt that for a minute. It certainly may. Are there some additional steps that you would suggest the Congress in this—and this committee in particular, needs to take to encourage long-term investment in savings?

Mr. REISCHAUER. I think the most important step one can take to encourage long-run investment in this country is to deal forcefully with the deficit. If you deal forcefully with the deficit, you are going to bring down long-term interest rates.

They are already substantially below where they were 2 months ago. Locking a substantial deficit reduction package in place and enforcing it with an extension and modification of the existing budget process will give financial markets some assurance that we really are on the path towards fiscal sanity, and that will do more than all of the little tinkering you might be tempted to do in the form of changes in tax legislation or particular spending items.

Mr. ANDREWS. Thank you. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Andrews. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome. I think that the attack on the President's approach to the budget is becoming more clear with every day or at least every weekend. Now it seems to be that the proposal for the future isn't as good as the 1990 package, and in any event, it is not enough. And I find that somewhat—it would be amusing if the subject matter weren't so serious, because the 1990 agreement is now raised as a better approach,

though President Bush renounced part of the 1990 agreement in the campaign.

The 1990 agreement had budget cuts and revenue increases in it, did it not, Dr. Reischauer?

Mr. REISCHAUER. Yes, it did.

Mr. LEVIN. So I really think it isn't fair to raise 1990 as something better than the Clinton approach when many renounced parts of the 1990 agreement. Now, let me talk about the argument that this budget approach isn't enough and it is illusory. Have you had a chance to look at Dr. Martin Feldstein's testimony?

Mr. REISCHAUER. No, I haven't.

Mr. LEVIN. Mr. Andrews referred to part of the testimony, the argument that the revenue increases were illusory because the behavioral response of taxpayers will undermine it and essentially, the majority of taxpayers who would face higher tax rates under the Clinton plan would actually pay less tax than they do under the current tax law.

You responded to Congressman Andrews that it is your understanding that the Joint Tax Committee and the Treasury Department take into account the behavioral response of taxpayers?

Mr. REISCHAUER. Yes.

Mr. LEVIN. Do you know what happened in terms of the 1990 revenue increases, whether they turned out to be illusory or not?

Mr. REISCHAUER. No, I don't think they did. I think they were quite genuine.

Mr. LEVIN. So on the one hand it is argued that the revenue—that there should be no tax increases, but then on the other, that people will end up paying less taxes. It really becomes confusing what the critics are saying. It is also true that up until now we really haven't seen a concrete alternative affirm the critics. I think we can do more and have to do more on deficit reduction.

You, Dr. Reischauer, essentially favor to the extent you favor anything, the action of the Budget Committee increasing the program cuts.

Mr. REISCHAUER. The two budget committees added to the deficit reduction in the President's proposal. I think that is the direction in which to go, until you get to the point where you are undermining the strength of the economy, but I don't think we are at that point yet.

Mr. LEVIN. So you think the Clinton original package has been strengthened by the budget cuts in the actions of the two budget committees and supported by the President?

Mr. REISCHAUER. Yes, I do.

Mr. LEVIN. One last point about the stimulus package. I don't remember your previous testimony. Do you feel that the rate of the recovery is such that the Congress should not look at any kind of stimulus package?

Mr. REISCHAUER. As you know, I don't get into the role of making recommendations on policy issues that are in front of the Congress. I have said in other testimonies that the strongest argument that one could make for a stimulus package is that it is the sugar coating that is necessary to get the Congress and the administration and the American people to swallow the bitter pill of deficit reduction.

There is also the clear possibility that the recovery that appears so strong could falter. It would not be surprising to me at all if the growth rate in the first quarter of this year, or the first half of this year, was moderately smaller than the growth rate that we experienced during the last half of 1992.

We had a growth rate then that was over 4 percent. It is conceivable that we will have a growth rate in the first part of this year that is under 3 percent. Whether that indicates some fundamental wavering of the recovery is an issue that is open to debate, and to the extent that the short-run stimulus package represents an insurance policy to bolster the economy, it might be viewed as a sensible move.

I think we should keep this in perspective, however. The stimulus package that the administration has proposed is really very, very small compared with the size of our economy. It is a package that would, at most, add a few tenths of a percentage point to the growth rate over the course of the next year or year and a half and probably, because of the nature of the package, would subtract from the growth that would occur in 1995.

Mr. LEVIN. Thank you, Mr. Chairman. I just urge when we look at the so-called recovery, and there has been one, it is not so-called. We look at the data, for example, on the nature of the jobs that have been created and the vast majority have been part-time jobs in recent reporting periods.

Thank you.

Chairman ROSTENKOWSKI. Congressman Thomas.

Mr. THOMAS. Thank you, Mr. Chairman. Good morning, Doctor. I don't want anyone to confuse your statement about the stimulus being sugarcoated to help the bitter pill go down. Usually sugar coating is done so that a person can take some medicine that will help that person. Clearly the stimulus package is designed to be the sugar-coating to get it through Congress, but the bitter pill will be swallowed by folks who aren't receiving the same medicine that is in the sugar part of the analogy.

It has been said that you can't argue that is better than the current proposal. There is, I think, a device that helps us understand, at least, choices that were made. Do you, off the top of your head, remember what the mix between tax increases and spending cuts was in that 1990 agreement?

Mr. REISCHAUER. Summed over the 5 year period, one-third of the $482 billion in deficit reduction provided by the 1990 package came from revenues and two-thirds came from spending cuts.

Mr. THOMAS. So one-third was tax increases and two-thirds was spending cuts. On page 3 of your testimony, you say, three-quarters of the cumulative deficit reduction contained in the administration's program would stem from increases in revenues and only one-quarter from cuts in outlays.

Mr. REISCHAUER. That is correct.

Mr. THOMAS. I think that is an objective ability to compare the two. Whether you voted for it or not, when three-quarters is coming from tax increases and one-quarter from spending cuts, as compared to the 1990 agreement of one-third in increased revenues and two-thirds in spending cuts, you can say you prefer one approach over the other. In your testimony, on page seven you say,

because the administration has not detailed its specific changes in debt management policies, the CBO estimate does not include budgetary savings.

I am sure you could have said that in a number of other areas, yet our colleagues on the other side continue to argue there are no concrete proposals. I think you will find that in many aspects of the President's budget, there isn't enough of a concrete proposal for you to be able to make an accurate estimate of what might occur in the dynamics of an area over a period of years; is that correct?

Mr. REISCHAUER. Well, there were a few other small areas—for example, reforming power marketing administrations—that we didn't have the detail for. As I pointed out in my testimony, on the discretionary side we take the President's proposals at face value, and if he says he is going to reduce budget authority by a certain amount, we will give him the associated outlay credit for that under our estimates of the outlay rates.

It might have different programmatic effects than he has suggested.

Mr. THOMAS. In the fifth paragraph on page 2 you say the difference between CBO's and the administration's estimate is largely accounted for by the administration's "inadvertent" use of different economic assumptions in estimating the effects of these proposals. I don't understand the word "inadvertent."

Can you give me some other definitions that might be found in a thesaurus or at least CBO's thesaurus to explain "inadvertent?"

Mr. REISCHAUER. I am going to give you——

Mr. THOMAS. Mistakes?

Mr. REISCHAUER. Mistaken would be an accurate word.

Mr. THOMAS. Sloppy?

Mr. REISCHAUER. Pressed by time, I would argue. This is a situation, from my understanding in which OMB and the decisionmakers asked the Health Care Financing Administration to do these estimates and gave them the proposals at a very late stage, at a stage at which they didn't have time to reprogram their models using new economic assumptions. I am not even sure that the folks at OMB knew the economic assumptions that these Medicare changes were being estimated on until after the fact.

Mr. THOMAS. On page 3 of your testimony, you say the existence of competing baselines and competing estimates creates considerable confusion. During the President's State of the Union Address, in what I assume was an ad-lib to a response on our side of the aisle when the President was quoting budget numbers, the President said, "Well, you can laugh, my fellow Republicans, but I will point out that the Congressional Budget Office was normally more conservative in what it was—in what was going to happen and closer to right than previous Presidents have been. Let's at least argue about the same set of numbers so the American people will think we are shooting straight with them." Despite this, you say the existence of competing baselines and competing estimates creates considerable confusion. Am I to assume then that the President's remarks when he says that you have been closer to right than previous Presidents includes the current one?

Mr. REISCHAUER. I will let history be the judge of that, Mr. Thomas.

Mr. THOMAS. When he said he thought we should be straight with the American people by using a single set of numbers, is your confusion over the fact that there is not agreement on a single set of numbers?

Mr. REISCHAUER. Well, what we have done in our report is provide you with estimates of the President's policies——

Mr. THOMAS. Why do you use the term confusion in your report? Is it because there are different sets of numbers?

Mr. REISCHAUER. Yes, there are.

Mr. THOMAS. OK. And he said that the American people will think we are shooting straight if we use the same set. I believe there is a movie called "The Gang Who Couldn't Shoot Straight," and if in fact most of the criticism has been that we haven't had a similar set of numbers to work with and it has been a problem with previous Presidents, I think it is fairly obvious it is a problem with the current one as well.

Chairman ROSTENKOWSKI. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. Dr. Reischauer, welcome, and thank you for your testimony. I found it very, very helpful. I would like to pursue some of the overall or the macroeconomic positions, particularly the characterization of the CBO estimates, and by that the estimates I suppose or the assumptions about the rate of growth or the GDP over time as being conservative.

Would you comment on the accuracy of that characterization?

Mr. REISCHAUER. CBO's economic forecasts for the short run have, in fact, been quite similar to those of the Bush administration. There has not been a lot of difference since the 1990 budget agreement in the short-run outlook predicted by the Council of Economic Advisers and the Congressional Budget Office. However, many budget decisions are made with a five-year window, and by and large, both Republican and Democratic administrations have assumed more robust economic growth in years three, four, and five of the projection period than we have at CBO. So the long-run outlook has often been quite a bit more optimistic under the administration's projections than under the Congressional Budget Office's projections, and the Congressional Budget Office's projections have been closer to reality, unfortunately.

Mr. PAYNE. As you look at this in an historical perspective, but as you look ahead, even those assumptions that are used by business, the Blue Chip indicators and others, aren't they generally higher than the assumptions by rates of growth, higher than those that are currently being used by CBO?

Mr. REISCHAUER. I believe the actual level of GDP 5 years from now in the Blue Chip forecast has been virtually identical to that of the Congressional Budget Office forecast, although the pattern of growth is different in the intervening years. By and large, if I remember correctly, we predicted more rapid growth over the next few years than the Blue Chip, but slower growth in 1997 and 1998 than the Blue Chip, but we ended up at about the same place.

Mr. PAYNE. So we should view this as a very realistic and not a rosy scenario as we look at the next 5 years in terms of the assumptions?

Mr. REISCHAUER. Our forecast is not a rosy forecast at all. It is a very middle-of-the-road, balanced look at the future that will exist if major steps aren't taken to deal with the deficit and change the economic course this country is on.

Mr. PAYNE. You mentioned that if CBO had reviewed the President's package, that you had found roughly $65 billion in differences, but yet table 1 shows that in 1997 if you look at the deficit that is projected, the deficit is actually slightly less than that that was proposed in the President's package. Is that correct? The $204.9 billion?

Mr. REISCHAUER. This is table 1?

Mr. PAYNE. Table 1.

Mr. REISCHAUER. You are talking about table 1 of a different report, I believe, not my testimony.

Mr. PAYNE. No, it is your testimony.

Mr. REISCHAUER. With respect to 1997?

Mr. PAYNE. With respect to 1997 the deficit.

Mr. REISCHAUER. CBO's estimate of the deficit is a few billion dollars lower than the President's estimate of the deficit. A lot of that difference is the result of different estimates of the baseline situation; the administration and CBO disagree on what the deficit would be if there are no changes in current policy.

We think it would be lower than the administration thinks it would be because we think more revenue will be coming into the system, even without policy changes, than the administration believes.

Mr. PAYNE. So is it accurate to say that in aggregate, if you look at the end result in terms of the deficit figure in 1997, that your assessment would be that you would agree—in essence agree with——

Mr. REISCHAUER. We agree with the bottom line number, but we get there through a different reasoning process.

Mr. PAYNE. To the extent we are successful as to the budget resolution of making those adjustments that you had suggested, then we will get to an even lower bottom line than either you or the President would have——

Mr. REISCHAUER. You would get to a deficit below $200 billion.

Mr. PAYNE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Neal will inquire.

Mr. NEAL. Thank you, Mr. Chairman. Doctor, the—one of the things I am struck by here on Capitol Hill is the rhythm of issues, how they tend to take on a life of their own, then interest subsides, and you didn't mention the S&L bailout this morning, which I still believe, having spent some time in purgatory over in the Banking Committee, that that issue is still with us, is it not?

Mr. REISCHAUER. It is still with us, and we have built into our baseline forecast an assumption that the Congress provides the RTC with the funds that it needs to take care of the S&L problem in full and that the resources are provided to the RTC in a timely fashion—in other words, that you should be acting as we are speaking right now.

We have an assumption that, over the 1993 to 1998 period, roughly $50 billion more will have to be appropriated for the final stages of the S&L cleanup and the capitalization of the SAIF, the

agency that is going to replace the RTC come September of this year.

Mr. NEAL. In your estimate, what has lower interest rates meant to the size of that deficit as you project?

Mr. REISCHAUER. Lower interest rates have strengthened the savings and loan industry, strengthened the banking industry, and reduced the costs of the S&L bailout, and we have reduced our estimate accordingly, both in January and more recently. It is good news, and if the lower interest rates that we are experiencing now lead to strengthening of economic activity, there will be further good news. But there is no getting around the fact that tens of billions of dollars are still going to have to be appropriated to clean up the remnants of this problem.

Mr. NEAL. As you preview the future, you went to 1998 and you have suggested, I think most agree, that the worst of the S&L bailout is behind us.

Mr. REISCHAUER. Correct.

Mr. NEAL. You are suggesting that we ought to get on with it?

Mr. REISCHAUER. The longer we avoid getting on with it, the costlier it will be to the American taxpayer in the long run.

Mr. NEAL. Given current interest rates, there is a sign of hope then that it will not cost what we originally assumed it would cost; is that correct?

Mr. REISCHAUER. Well, it certainly is not going to cost as much as CBO feared it would cost several years ago. Our numbers are down by tens of billions of dollars.

Mr. NEAL. Do you have rough parameters?

Mr. REISCHAUER. I don't have the rough parameters today, but I will be talking about that tomorrow before the banking subcommittee.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Mr. REISCHAUER. I can provide the numbers for the record.

Mr. NEAL. I would like to take a look at those.

[The information follows:]

For purposes of summarizing the long-term costs of the savings and loan crisis, the most useful measure is a present-value estimate of past, present, and future net costs of resolving failed thrifts. (The federal budget, in contrast, records the yearly net flows of cash in nominal dollars.) The Congressional Budget Office (CBO) now estimates that losses in failed financial institutions will cost the Resolution Trust Corporation (RTC) or its successor $120 billion on a present-value basis, bringing the total cost of the thrift crisis to $180 billion since 1980.

The $120 billion estimate for cleaning up the thrift crisis is $15 billion lower than the estimate CBO prepared last summer, reflecting continued improvement in the condition of the thrift industry. Our analysis of the financial condition of the thrift industry in recent quarters suggests that fewer institutions are facing insolvency, and that the losses associated with resolving those thrifts are diminishing. The removal of many hemorrhaging thrifts, the unusually wide spread between borrowing and lending rates, and changes in law and regulatory behavior have all contributed to this improvement. Several different methodologies used to estimate future losses seem to confirm this pattern and provide the basis for the projections.

Despite this reduction in the estimated size of the problem, a significant number of problem thrifts still require closure and resolution. CBO expects that the Congress would need to appropriate about $50 billion to the RTC or the Savings Association Insurance Fund (SAIF), its successor agency, to cover the remaining shortfall in losses form insolvent thrifts and to build the SAIF's reserves to the level specified in law by 1998.

Chairman ROSTENKOWSKI. Mr. Shaw. Mr. Hancock. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Dr. Reischauer, the economy, according to the releases that I have seen, grew 3.4 percent in the third quarter of 1992 and 4.8 percent in the fourth quarter of 1992. In a normal recovery or in any recovery, is it normal for the gross domestic product not to continue in an upward spiral, but to level off and grow at a lesser rate than, for example, 4.8 percent in the first quarter of 1993? What would you project the normal recovery growth rate to be?

Mr. REISCHAUER. Quarterly rates of growth bounce around a lot, and I don't think we should design economic policy to try to smooth out quarterly rates. It would be a futile exercise. The growth in the last half of 1992 exceeded the underlying strength of the economy; we had a more rapid growth of consumption than of income, so saving rates went down.

It is likely that in the first half of this year, households will attempt to shave a little bit off of their consumption to add back to their savings balances. The problem during 1992, as Mr. Levin has pointed out, is that we had very weak growth of employment and very weak growth of incomes, so we are now resting our hopes for a continued modest recovery on the expectation that we are going to get some substantial increases in employment over the next few months.

Mr. BUNNING. But isn't it normal when you go into a recession, that the last numbers would be affected are employment numbers? And when you come out, it seems that they are the last numbers to go the other way.

Mr. REISCHAUER. That is true, but we have been in a very long period of economic purgatory. The recession officially ended in the spring of 1991 and here it is 2 years later. The growth that we experienced——

Mr. BUNNING. But in numbers, you are talking about the numbers, according to the feeling of the American people, it didn't end until after the election.

Mr. REISCHAUER. That was because——

Mr. BUNNING. The numbers that you are talking about.

Mr. REISCHAUER. Correct. The problem was that the recovery was occurring at such a slow pace that it was not apparent to many in America. Of course, the news was dominated by corporate restructures and layoffs, which cast a pall over the American public.

Mr. BUNNING. Let me get to one other question. The President's budget claims to create jobs, particularly through the stimulus package. Given the present forecasts for the economy, why in the world do we need a stimulus package right now and why would it be good? If it is such a huge economy, 7-trillion-plus dollars, why would a stimulus package of approximately $31 billion have any effect at all except very short term?

Mr. REISCHAUER. As I pointed out in my answer to a previous question, it would have a very tiny impact. Remember that one aspect of the stimulus package was an extension of the unemployment provisions that we had, and that has already been passed. What remains——

Mr. BUNNING. It has not been paid for either but it is on the bottom line of the deficit for 1993.

Mr. REISCHAUER. Right. What remains is a decision with respect to the investment tax credits and the spending. The spending, as you know, will take many months to get into the American economy because much of it is infrastructure-oriented and those programs spend money at a very slow rate. So the full impact might not be felt for a year or so.

Mr. BUNNING. OMB shows unemployment under the budget policies as dropping only 0.3 percent when fully enacted by 1998. What is CBO's estimate on unemployment over the period of this package?

Mr. REISCHAUER. We have not done a new forecast that would provide a new unemployment rate. Overall, given what I said before, which is that GDP under this proposal will be very little different than it would be under a baseline forecast, I would expect our unemployment rate, if we did this kind of exercise, to be roughly that of our baseline forecast.

Mr. BUNNING. In other words, are you saying that you are going to differ from OMB or that your projections would be similar?

Mr. REISCHAUER. Our projections, I think, would be very little different from what they are right now. In a sense, that is good news. What a deficit reduction package does, remember, is apply a dose of fiscal restraint to the economy. It increases taxes; it cuts government spending. Those factors slow down the economy.

One would expect deficit reduction over a 3- to 5-year period to lead to a modest reduction in GDP and a modest increase in unemployment. However, if we get a good response with respect to interest rates, that can offset the contractionary impact of fiscal restraint.

Mr. BUNNING. You don't believe that interest rates are going to get better? You mean interest rates are going to stay the same or grow very slightly. You can't believe they are going to get better?

Mr. REISCHAUER. I am not in the business of predicting interest rates from that standpoint. It is probable that short-term interest rates will rise gradually over the next couple of years as the economy strengthens. Long-term interest rates have come down substantially over the last 2 months.

If there is a significant budget package adopted into law and some reinforcement of those decisions with an extension of our budget enforcement procedures, it would not surprise me at all to see long-term rates inch down a little bit from where they are now.

Mr. BUNNING. Thank you.

Chairman ROSTENKOWSKI. Mr. Hoagland will inquire.

Mr. HOAGLAND. Thank you, Mr. Chairman, and welcome to the committee, Mr. Reischauer. The precision you bring to these issues is always very helpful. I would like to talk for a moment about the incremental investment tax credit, the credit that corporations of over $5 million are entitled to take advantage of under the President's proposal on a temporary basis and I wonder first of all, if you have scored the cost of that, if you could tell us what—approximately what it would cost if we implemented that as proposed?

Mr. REISCHAUER. The numbers that we have on that are from the Joint Committee on Taxation. They do the revenue estimating. I believe the cost is roughly $12 billion over the next 5 years.

Mr. HOAGLAND. And the duration of the proposal, Mr. Reischauer?

Mr. REISCHAUER. The large-scale revenue losses from that would be in 1994 and 1995, but then the effect tails off, and there is really no appreciable impact by the time we get to 1997 or 1998.

Mr. HOAGLAND. And the credit itself is a 2-year credit; is that right? It is due to expire in 2 years?

Mr. REISCHAUER. Yes.

Mr. HOAGLAND. Now I visited with a number of corporate leaders about this myself, both in Omaha and outside of Omaha and they are telling me that they would be happy to take the credit, take the tax benefits, but that it will not affect their investment decisions basically.

I noticed in response to the Chairman's question on this subject, you indicated that you thought that large corporations might respond around the edges and they might even shift some spending forward but that would have the effect of reducing longer term economic activity if they did that.

Mr. REISCHAUER. It largely affects the timing of investment, rather than the longrun overall level of investment.

Mr. HOAGLAND. And that wouldn't necessarily have a longrun overall beneficial effect because it would simply move forward some investments; is that right?

Mr. REISCHAUER. Correct. It would have a very modest impact in the long run.

Mr. HOAGLAND. Now, Mr. Reischauer, is this one of those features that you referred to earlier in response to questions by the Chairman that would turn away from the 1986 reforms?

Mr. REISCHAUER. Well, the investment tax credit we had at that point was a permanent one, and this is temporary and clearly designed solely as a stimulus measure to help the economy along. But in the sense that it is a special provision similar to ones that we have had in the past when we had a more complex Tax Code, the answer is yes.

Mr. HOAGLAND. Now, I also understand that roughly speaking, this would spend about the same amount that a 1 percent, one of the two proposed increases in corporate taxes would raise. Is that right?

Mr. REISCHAUER. That is roughly correct.

Mr. HOAGLAND. So it is roughly a wash in terms of——

Mr. REISCHAUER. Over the 5-year period, but a 1 percentage point reduction in the corporate tax rate would of course go on and on.

Mr. HOAGLAND. But in 5 years—it would be a wash over 5 years?

Mr. REISCHAUER. I believe the 1 percent tax rate reduction is slightly larger than this, so it is not quite a wash, but it is in the same ballpark.

Mr. HOAGLAND. Now, I am also told that about——

Mr. REISCHAUER. It is sort of, let's say, roughly $16 versus $12 billion.

Mr. HOAGLAND. I am also told that about 40 percent of the benefits of incremental investment tax credit would go overseas.

Mr. REISCHAUER. I don't have an independent estimate of that.

Mr. HOAGLAND. All right.

Mr. REISCHAUER. Certainly, a substantial chunk of the equipment that manufacturers and businesses buy is produced abroad.

Mr. HOAGLAND. Now, if we were to use the standards, the three general standards that we try to apply to proposed changes in the tax laws, fairness and simplicity and efficiency in growth, which would be—which would more likely promote those three goals, the temporary investment tax credit as proposed by the President or cutting in half the proposed increase in corporate income taxes?

Mr. REISCHAUER. Well, on those three dimensions, certainly it would be cutting in half the corporate tax increase. But I think we have to add another dimension, which is the motivation behind the President's proposal, and that is shortrun economic stimulus. On that fourth dimension, a temporary investment tax credit would come out ahead.

Mr. HOAGLAND. That is assuming that it would, in fact, affect corporate behavior to a significant degree.

Mr. REISCHAUER. Even to a modest degree.

Mr. HOAGLAND. If it affected—you mean if most of it were windfall and some of the affected——

Mr. REISCHAUER. Certainly, to the extent that there is a windfall element included, you are correct, but by making the tax credit incremental, there is an effort to reduce that windfall portion. Of course, by reducing that, one inevitably has to produce a complex system of regulations and monitoring devices.

Mr. HOAGLAND. Mr. Chairman, if I can ask one more brief question, I would like you to again use the standards, Mr. Reischauer, of fairness, simplicity and efficiency in growth and tell me which would be more consistent with those standards, this incremental investment tax credit or simply applying the $12 billion that it would cost against the deficit.

Mr. REISCHAUER. You know, once again, we are comparing apples and oranges. On the simple grounds that you are laying out, in which you are setting down the rules, you get the answer you want.

Mr. HOAGLAND. Which is what?

Mr. REISCHAUER. Which is deficit reduction.

Mr. HOAGLAND. Thank you, Mr. Chairman. I have no further questions.

Chairman ROSTENKOWSKI. Mr. McNulty will inquire.

Mr. MCNULTY. Thank you, Mr. Chairman. Dr. Reischauer, one of the issues that has been mentioned here this morning, although very briefly, is health care reform. Most people recognize that that has a lot to do with our ability to impact deficit reduction in the years ahead. Almost everybody in this town has said that they are in favor of comprehensive health care reform.

The only problem is that everyone has a different solution, and there is no consensus yet on what we ought to do. The President in his State of the Union Address emphasized the need to move quickly on this issue. What concerns me a little bit is the subsequent idea of trying to link health care reform and deficit reduction in the same package. My fear is that if we try to do that, we could end up sinking both of them. It occurs to me that there is something of a consensus right now on deficit reduction in general, and the President's plan in particular. But we are not even at the be-

ginning of a consensus, in my view anyway, on health care reform. What is your view as to the advisability of trying to link these two issues?

Mr. REISCHAUER. Well, I am not in a position to advise the leaders of Congress on how to order the legislative schedule. I share your concerns in the sense that health care reform is going to involve substantial restructuring of a major segment of our economy—14 percent of our economy is now in the health care sector.

This is an issue that is going to affect many people. It is going to raise concerns and cross the jurisdictions of many committees within the Congress, so inevitably it is going to be an extremely complex legislative scheduling process to get substantial health care reform through the Congress.

Deficit reduction also is a very complex issue, one that, when the reconciliation instructions that go along with the budget resolution are completed, will also affect a great many committees within the Congress, and it has not proven easy in the past to get omnibus reconciliation measures through the Congress.

It has been nip and tuck, and one certainly can question whether putting these two very complex issues together wouldn't just choke the process entirely.

Mr. MCNULTY. Thank you. On deficit reduction in particular, you mentioned in your statement that we anticipate a budget deficit this year of about $322 billion and that if the Clinton program is enacted, by the time we get to 1997——

Mr. REISCHAUER. That was a 1997 number, $322 billion. If we did nothing now but continue programs on automatic pilot, so to speak, CBO estimates that in 1997 the deficit would be $322 billion. This year, 1993, we expect the deficit to be $302 billion.

Mr. MCNULTY. $302 this year?

Mr. REISCHAUER. Up from $290 last year.

Mr. MCNULTY. And in 1997, with the implementation of the Clinton plan, we would go to the $205.

Mr. REISCHAUER. Correct.

Mr. MCNULTY. OK. Now, did you also say that when we get to that point in time, if we wanted to move toward a balanced budget by the year 2003, that we would need to enact another deficit reduction plan about twice as big as the one we are doing right now?

Mr. REISCHAUER. I actually used 1997 as the implementation date, simply because this is 1993 and the last time we took a bite out of this apple was in 1990. Let's presume that the Congress gets back together with the administration 3 years from now, in 1996, and enacts a program that would start in 1997. The size of that program over the ensuing 5 years would have to be a little bit more than twice as large as the package that the President has proposed to you now.

Mr. MCNULTY. Let me get to my question before my time runs out. Although I am not fixed on trying to tag a particular year for getting to a balanced budget, every time I go home and look at my four daughters and think about the children of this country, I think that I would like to be around when we see a balanced budget in this country and begin to reduce the national debt instead of increasing it every year. Considering the fact that it might be difficult to expect that we would do a deficit reduction package that

large in 1997, how long would it take for us to get to a balanced budget if we did something similar to what we are doing now and move along those lines?

How long would it take, practically speaking? Just a guesstimate to get to a balanced budget.

Mr. REISCHAUER. In a way that is an unanswerable question because much depends upon the composition of these deficit reduction packages.

Mr. MCNULTY. You gave an estimate of how long it would take if we enacted a package twice as big as the one that we are doing right now, so it would seem to me that we would be able to project how long it would take if we did a package the same as the one we are doing now.

Mr. REISCHAUER. And then did another one 3 years later and another one 3 years after that——

Mr. MCNULTY. Yes.

Mr. REISCHAUER [continuing]. Of equal size.

Mr. MCNULTY. Yes.

Mr. REISCHAUER. You would probably be looking at the second decade of the next century, but what I was going to say was that a lot depends on the composition of these deficit reduction measures. If a substantial component of the next package were to be some kind of reform in our health care system that in the long run would hold down Medicare and Medicaid spending, you might get a much shorter glide path because it is, after all, Medicare and Medicaid that are driving us into these large deficits.

Mr. MCNULTY. Thank you, Dr. Reischauer. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman. Dr. Reischauer, welcome back. I think you testified earlier this morning that you thought the net effect of the stimulus package in terms of an economic stimulus would only amount to a few tenths of a percent, isn't that correct?

Mr. REISCHAUER. That is correct.

Mr. GRANDY. Would you define that as enough to provide insurance against the recurrence of a recession, just from what you have seen of the package?

Mr. REISCHAUER. No, but I don't think there is a danger of a recurrence of a recession, defined as a recurrence of negative growth of GDP.

Mr. GRANDY. I wanted to say that as a prelude to what I really wanted to query you about, which is, can you provide for me the true definition of emergency as it is laid out under the 1990 act as a designation for emergency spending. In your view, as the Director of CBO, what do you see that as?

Mr. REISCHAUER. My definition would be that when political leaders at both ends of Pennsylvania Avenue regard something an emergency, it is an emergency.

Mr. GRANDY. That I think is the best answer you will ever give in front of this committee, Dr. Reischauer.

Mr. REISCHAUER. Can I go home now?

Mr. GRANDY. Let me just read for you something that was apparently used during the Bush administration and then was concurred

to, as I understand it, by the Clinton administration. I am reading from a letter by the current Budget Director, Leon Panetta, to the ranking member of the Appropriations Committee, Joe McDade and he calls it, I am quoting now, "A necessary expenditure that is sudden, urgent and unforeseen and is not permanent," and, he goes on to say, "depends upon common sense judgment made on a case-by-case basis about whether the totality of facts and circumstances indicate a true emergency about whether the needs can be absorbed within the existing level of resources available." Mr. Panetta says at the end of this paragraph that he believes this definition has worked reasonably well.

So the reason I asked you the question about the stimulus package is that the quote to provide insurance against a recurrence of a recession is what the Budget Director also says is the justification for the emergency stimulus package. I guess I would ask you, having looked at the upcoming dire emergency supplemental that we will be obliged to pass simultaneously with the budget resolution, do you think these really meet an emergency criteria beyond the kind of obviously carefully thought out political response you made?

I am wondering about this in terms of urgent, unforeseen, not permanent and something that really justifies an emergency borrowing of future funds. Could I have your thoughts on that?

Mr. REISCHAUER. Well, this certainly isn't a response to a hurricane or a civil disorder of some kind, or an international crisis like the Gulf War or the starvation of Kurds or Bangladesh refugees from the typhoon, so in that sense it is quite different. I thought Director Panetta's definition was actually quite a good one, but of course it comes down to the interpretation of three words, "common sense judgment" and——

Mr. GRANDY. I think there is going to be a dispute over that. Let me follow something else. Isn't it true that there are unobligated balances remaining in many of the accounts that the supplemental will add to and that even if you could justify an emergency, you could probably absorb the needs within the existing level of resources available? I just, for example, am looking at a request by the Department of Agriculture for another $37 million to the Agricultural Research Service which would provide for buildings and facilities for the ARS.

My understanding is there is about $650 million in the account now. Supplemental would add $37 million as an emergency designation. I am just hard pressed to understand any definition that says this justifies an emergency borrowing: So many of our colleagues up here this morning have talked about the problem with the deficit in the out-years and I wanted to get your feelings on that.

Mr. REISCHAUER. I think the issue here is that we are right up against the caps for fiscal year 1993 for domestic discretionary spending, and so new budget authority cannot be provided under the Budget Enforcement Act's limits unless it is provided through the emergency provisions and therefore not counted against the limits. While there might be resources available in the defense accounts, we do not have the flexibility to spend those resources on domestic programs because of the Budget Enforcement Act's limits.

Mr. GRANDY. But is it not true that about half, I believe, of the $6.8 billion that you specified would be added to the deficit this year, comes, at least part, from the itemized list that is under the emergency supplemental requirements? In other words, that a lot of the spending that we tack on to fiscal year 1993 is coming from——

Mr. REISCHAUER. The stimulus package, correct. A big chunk of that, however, is the Emergency Unemployment Act that was passed several weeks ago. We would suggest that the outlay ramifications of any emergency supplemental on discretionary spending would largely appear in fiscal years 1994 and 1995 because the rate of spending is so slow in many of these programs.

Mr. GRANDY. Thank you, Doctor. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Reynolds.

Mr. REYNOLDS. Thank you, Mr. Chairman. Nice to see you again and thank you so much for coming over today. It is very enlightening. There is a lot of talk in the press and a lot of talk which says we already have an economic recovery and so why are we so pressed to do the stimulus package. Can you react to that, please?

Mr. REISCHAUER. Well, we have had some pretty good growth rates in GDP over the last 6 months and that leads economists and green eyeshade types to talk about a strong recovery. But the American people, I think, define a recovery in more basic terms, namely jobs and what is happening to the growth of their incomes. In that respect, the recovery has been one large disappointment, and we had not seen much movement until we saw the February employment numbers.

Now, if those employment numbers are a harbinger of the future, we will all breathe a sigh of relief and know that employment and incomes will grow. But there is a good deal of uncertainty surrounding that proposition, and I think many Americans are understandably concerned about the restructuring and downsizing that is going on in many of our most visible firms in America.

Mr. REYNOLDS. Thank you. That was a good answer. One of the assumptions in the economic stimulus reduction package is that all people eligible for earned income tax credit and food stamps will utilize them. Is that a fair assumption?

Mr. REISCHAUER. It is certainly not a fair assumption. There are substantial numbers of individuals who don't apply for food stamps although they might be eligible, and the same is true for the earned income tax credit, although the IRS has in the past filled out the EITC form for individuals who they thought were eligible and provided them with the refund even though they hadn't asked for it.

Mr. REYNOLDS. Does the CBO use particular rates to make the projections in these particular programs? If the assumption is not true—if that is not a fair assumption, then do you——

Mr. REISCHAUER. We have our own models for estimating, let's say, changes in food stamps, and those have built into them our view of what participation might be in those programs and how it might change. We don't accept the administration's models or assumptions on this score.

Mr. REYNOLDS. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Coyne. Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman. I find it interesting, your discussion on the stimulus package and that it would be a tiny impact, positive now and possibly a negative impact later. Certainly there would be some increase in revenues from jobs created under that.

What number would you consider as a net loss in that?

Mr. REISCHAUER. Let me ask you to repeat that. I want to clear up one thing: I said the temporary investment tax credit portion of it would have a positive impact in the short run and then a slight negative impact 3 years from now. The package as a whole would be a net positive, I believe, for the duration of its impact.

Mr. BREWSTER. So the stimulus package as you view it would not increase the debt?

Mr. REISCHAUER. It would not increase the debt?

Mr. BREWSTER. Right.

Mr. REISCHAUER. No, it would. To the extent that it involves increased Federal spending or reduced revenues, it is going to increase the size of the debt.

Mr. BREWSTER. With interest rates——

Mr. REISCHAUER. And the added growth of the economy that results from this few tenths of a percentage point stimulus is not going to offset that increase.

Mr. BREWSTER. Do you have an idea of how much it would increase the debt and what that would amount to in an annual increase?

Mr. REISCHAUER. No, I don't have those figures for you but I could look into it and give you the orders of magnitude for the record. I think they are relatively small.

Mr. BREWSTER. With interest on the debt running about 14 percent of our total budget now, I think it is certainly of relevance.

Mr. REISCHAUER. It certainly is.

Mr. BREWSTER. Another point, on the Btu tax, on any tax you do there are winners and losers. Some of my constituents are saying that two of the biggest losers in this are the fertilizer industry, which certainly affects agriculture, and the trucking industry, which certainly moves a lot of our agriculture products as well as everything else. Do you see those as being larger losers than most in this Btu tax scenario?

Mr. REISCHAUER. We have not done a study of that issue ourselves. But from what I have read and seen, I think that is a correct judgment on your part.

Mr. BREWSTER. When you have an opportunity, I would like to see that. Another thing that I think is certainly a problem for small business, in the tourism industry, is the reduction in the deductibility of the business meal side. As one who is a former chairman of tourism in Oklahoma, I find that any change in that deductibility can be devastating to the employability of many marginally employable people. I personally feel we could have a considerable job loss there. I also see it as a problem for the other industries I was talking about, like trucking companies who have a lot of over-the-road drivers and a lot of small business people who utilize that because they can't advertise on a big scale.

Am I correct in my assumption?

Mr. REISCHAUER. I think that is a problem, but we have to keep all of this in perspective. It is virtually impossible to cut spending by reducing the levels of existing programs or to raise taxes by closing off preferences or loopholes without disproportionately affecting one segment of our society, one sector of our economy.

There is no way to spread the sacrifice absolutely evenly among the American people.

Mr. BREWSTER. I will probably be coming to you to see if we can get some figures on that and certainly try to spread it a little more evenly in some cases.

Thank you.

Chairman ROSTENKOWSKI. Mr. Camp. Mr. McCrery, Mrs. Johnson. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman. Dr. Reischauer, nice to see you today. We are lucky to have you in your job. Let me just ask you a very sort of a basic broad-gauged question.

Mr. Grandy was talking to you about emergency and how you would define that. I would like to get your opinion, if you would give it to me, on where we ought to end up. Let me just break this down a little bit. There have been an awful lot of numbers floating around here in terms of what we ought to do and how we ought to do it, but it seems to me that the President has given us a call, and that we want to respond in our own way to that call.

Yet at the same time I understand there will be some pain, some sacrifice, people laid off, unsettling conditions. Now, that isn't too bad as long as when we get to the end of that 5-year period, we are where we want to be. I guess the hang-up I have had is I don't know where we want to be because the critical issue to me is the ratio of debt to the GDP.

We ought to be bending that curve down. Specifically where do you think we ought to be at the end of this 5-year period in terms of any set of criteria you consider important?

Mr. REISCHAUER. It is very unlikely that at the end of this 5-year period we could be where we would want to be in the long run. The issue, I think, is to march down the deficit reduction path in as rapid a fashion as our political system and our economy can handle without disrupting either the economy or the political system unduly, and that is a judgment call.

It is something that probably has to be decided on a year-to-year basis. I think the package presented by the Clinton administration is a significant step in the right direction. I would hope that as we go down this path, we could take another step, at least as significant, before the fifth year. I suggested the order of magnitude that we would have to be willing to accept if our goal was a balanced budget in the first few years of the next century. I think one can make a plausible case that we want to go further than that or not that far.

There are other issues affecting our country besides the deficit. Right now that is an overwhelming issue, and one that affects this country and our future in a substantial way. But it could be that as we get the deficit down to around 1 percent of GDP—when we get it to the point where the debt-to-GDP ratio is falling, as it was through the entire postwar period up until the mid-1970s—that we will say to ourselves, the most important thing for the long-run fu-

ture of this country is really getting our education system in shape, training our youth so that they can compete in world markets.

Mr. HOUGHTON. Can I interrupt just a minute, Doctor? So what you are saying, if I understand it, is that the key criteria is getting your debt to the GDP on a downward slope?

Mr. REISCHAUER. Correct.

Mr. HOUGHTON. And if I understand you further, that you probably can't do that in a 5-year period, you have got to look beyond that?

Mr. REISCHAUER. No. I am sure we can get to the point where it is declining.

Mr. HOUGHTON. So that curve, that trend, ought to be bending down at the end of the 5 years?

Mr. REISCHAUER. I haven't looked at the exact numbers that would bring that about, but I would hope that we could achieve that.

Mr. HOUGHTON. Thank you, very much.

Chairman ROSTENKOWSKI. Mr. Kleczka. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman. Mr. Director, I like to believe that we have used honest figures in our assumptions on this bill that is before us and that in general we are on target. I notice there are some differences between your estimates and those of OMB, but are we safe in saying that though there are some differences in some areas, overall the figures are pretty much on target? Pretty much—are you in agreement?

Mr. REISCHAUER. I think there are some modest differences between the Joint Committee on Taxation and the administration with respect to the revenue estimates. On the spending side, most of the differences between OMB and the Congressional Budget Office estimates really are mistakes that were made by OMB in the hasty preparation of a very complex budget document and are not areas on which the analysts at CBO and OMB would differ at all.

Mr. PICKLE. Well, my concern, and I think that of the average Member of Congress, is if we make this step, adopt the budget as is, are we generally in agreement? We may differ on one individual spending aspect or one revenue aspect, but within the big parameters of the budget, overall, are we generally in line?

Now, I think though that after the 4 or 5 years we are talking about, it looks to me, and I think your testimony says that in effect, we will have just about broken even about the revenue and the spending. To me that means that at least for the next 4 to 5 years, we are not going to be going in the hole. If nothing else, we will at least be holding our own, but the big plan that says we can save a lot of revenue in the health aspects is probably not realistic.

We have been told and we have to assume the health bill is not going to do it. So after the four to five years, we may be kind of breaking even, that is, we are not going in the hole further, and at that point we got to think in terms of what do we do for the next big step.

Mr. REISCHAUER. I think that if, over the course of the next couple of years, some substantial steps are taken to reform the health care system in America, very substantial dividends will be reaped by the Federal budget around the turn of the century or beyond.

But you have to take those steps now to be able to reap the dividend 10 years from now.

Mr. PICKLE. Yes, all right. Now, I noticed in your answers earlier you said that the Congress may be faced with the choice of raising some $20 billion for the RTC, that if they are to have funds that they need to close out all this S&L problem, that that money——

Mr. REISCHAUER. Closer to $50 billion.

Mr. PICKLE. That they have $50 billion that they need, or whatever they ask for, is that in your baseline?

Mr. REISCHAUER. That is built into our baseline, and the administration has built into its baseline a smaller number, but still a substantial amount of money.

Mr. PICKLE. Relatively the same figure. So that is an assumption that is in the baseline and it will not be an add-on if it happens.

Mr. REISCHAUER. Enacting that legislation is not going to cause us to change our baseline forecast, and enacting a substantial portion of it wouldn't cause the administration to change.

Mr. PICKLE. I think we would be asked to make those appropriations and I think we probably should do it, but I don't know whether Congress will. But if we did, it wouldn't be an add-on. That is my main point, okay. I thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman, and thank you once again, doctor. In your earlier testimony, I think you were talking about projections of the increase in the deficit if we didn't do anything and I think also someone asked where do you see the causes for this increase, and you said Medicaid and Medicare.

When you make these projections, do you look and see what particular ailments will cause the explosion in the health area?

Mr. REISCHAUER. No, we do not.

Mr. RANGEL. Well, if I wanted to know what role does the narcotics abuse play in terms of those being treated in the hospital or what role does drug rehab play and the cost of it in terms of projecting what the health costs would be in the future, would your office have any information on that?

Mr. REISCHAUER. We would be unable to do that simply because the medicaid information system is, to put it charitably, poor, and it doesn't collect information of that sort, nor do I believe is there medicare data of that sort. It just isn't available, although it is terribly important, and that certainly has been an element that has contributed to the very rapid growth of health care costs in this country.

Mr. RANGEL. But administrations in the past have used emergency treatment as some indication of the rise or fall of abusive drugs. I mean, that data is supposed to be available. You know what I am talking about?

Mr. REISCHAUER. I think what they are referring to is a method which people coming into emergency rooms for services are tested for HIV and for drugs in their blood. This is done from a sample of hospitals, and it is collected and aggregated by the Federal Government and tracked over a period of time, but it is by no means comprehensive, nor do we know who paid for the services.

Mr. RANGEL. Suppose I wanted to know how many babies were born addicted to cocaine. There would be no way to find out?

Mr. REISCHAUER. I am not an expert in this area, but I think there would be no way to find out.

Mr. RANGEL. You are not an expert, but the CBO manages to find the experts to get the information.

Mr. REISCHAUER. We will find the expert on this topic and see if there are data of that sort collected.

Mr. RANGEL. Let me say this: You also indicated in the response to a question about the necessity of investing in training of young people and I think you were talking about improving the work force and making it competitive, were you not?

Mr. REISCHAUER. Yes, I was.

Mr. RANGEL. Now, do you have information as to what that work force looks like today and how many kids have dropped out of school, how many——

Mr. REISCHAUER. Certainly that kind of information is collected.

Mr. RANGEL. And how many people are in jail and how many people are returning to jail and how do they leave the jails, are they better when they get out than when they went in, and how many—what does our work force look like and what do we have to do in this Clinton package in order to make certain we have a better trained and more competitive work force? Do you have access to that type of information?

Mr. REISCHAUER. That is a matter for analysis. I mean, what do we have to do? That is a very difficult kind of question.

Mr. RANGEL. I am talking about where we are. In other words, if we are going to fix it, we got to find out where we are.

Mr. REISCHAUER. There are measures of the educational attainment of the work force and how that has changed over time, the job experience and wages of the work force.

Mr. RANGEL. Doctor, let me try to make the target a little smaller. We are having this investment in job training and we are going to create 500,000 jobs and 8 million over a 5-year period and I am anxiously supporting this. Now, how would I know what training is necessary in my particular community, how would I know that these programs are geared toward the problems that I am having? How would I know that these are not jobs for high school graduates or how can your office better help me and others in determining exactly what we need?

Mr. REISCHAUER. Well, the Labor Department does surveys and projections of where the job growth is going to be—in other words, what kinds of occupations, are going to be needed in the future, and what training is associated with those occupations. And that can be compared to the raw material in a sense, the young people in your particular area, to see if those people are getting trained in ways that would allow them to fill the jobs that are being created.

Mr. RANGEL. Doctor, could the CBO kind of do some type of survey to see what the cost is in our country annually of drug abuse, what the social cost is to lost revenue, lost productivity?

Mr. REISCHAUER. We have tried to do that for you in the past and have provided as much as we could ferret out from the available data. I will look into that again and try to update the estimates that we provided you.

Mr. RANGEL. Thank you, doctor. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman, and welcome, Dr. Reischauer. I want to go back to comparing apples and oranges and I think it may be a nicer way of putting it to use kind of a matrix idea on this following up on Congressman Hoagland's line of questioning.

I am curious about let's say that we have this half of the corporate increase, 1 percent of that, which is about $12 or $16 billion as I recall; is that correct?

Mr. REISCHAUER. Yes, sir.

Mr. KOPETSKI. And we take that money and we want to look at what is better or the effects of that on two different items. One is short-term stimulus for the economy and another item is longer term stimulus or growth for the economy and then the other item is the effect on industrial—the industrial sector of our economy versus service sector of our economy, and if there is any kind of a different effect, and I think starting with the ITC, what I hear in your testimony is that it pulls forward investments today essentially, or in the next 18 months, and so the value of it is short-term stimulus, and I would guess that it is more for the industrial sector of the economy versus service sector. That is a question, I guess.

Mr. REISCHAUER. I don't have a breakdown of the extent to which the service sector versus the manufacturing sector of the economy could take advantage of an investment tax credit. Both obviously could make investments in many ways. Service-sector investments are smaller and therefore can be obtained or behavior can be changed more rapidly than some of the large corporate investment decisions that are made in a plant and involve major kinds of equipment. Remember, we are talking here about the possibility of reducing the increase in the corporate tax from 2 percentage points to 1 percentage point. That, in and of itself, would reduce the revenue coming in under the Clinton administration's proposal. That would lead to a higher deficit if that is all you did.

The higher deficit would have all of the damaging implications that we are trying to avoid. So you have to think about what you are going to give up or trade off against this revenue that you have now given away, and what the advantages are of that alternative policy.

Mr. KOPETSKI. Let me move on then to two other aspects of this matrix that we are creating in our minds here. One is the effect of, if we took that, those moneys from the corporate tax and used it to reduce the double tax on corporate earnings, that is, some sort of credit towards the taxation on dividend, the effect, if any, on short-term investments versus long-term.

Mr. REISCHAUER. You are compounding the damage here. You have reduced the revenue going into the Federal Government by lowering the increase in the corporate tax. Now you have to cut some program or raise some taxes to offset it. You can't give it away again with a proposal to reduce the double taxation of corporate income.

Mr. KOPETSKI. Let me frame it a different way. Instead of spending that money, if you will, implement the corporate tax, 2 percent increase.

Mr. REISCHAUER. Two percent, OK.

Mr. KOPETSKI. Use that money, instead of on ITC, use it on moving toward elimination of the double tax on earnings, corporate earnings. Where would that come in in terms of short-term economic——

Mr. REISCHAUER. In a short-term sense it would do very little, but it would have a longer-run benefit. So we are really looking at a shortrun versus a longrun policy change here.

Mr. KOPETSKI. Then I guess we should compare then the tax——

Mr. REISCHAUER. What you are comparing with the temporary investment tax credit is using the same amount of money to reduce the double taxation of corporate income in some way. To do that in a substantial way would require far more money than the temporary investment tax credit spends, and it would be a persistent revenue loss, so you would have to come up with some alternative that provided permanent revenues to offset this, rather than a temporary proposal.

Mr. KOPETSKI. OK. Thank you. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gibbons, Mr. Stark, Mr. Crane.

Mr. CRANE. Just one question, Dr. Reischauer. I have been going back and trying to find the reference in your statement, but my understanding is that we would have a deficit under the administration's proposal in 1998 of $130 billion; is that right? Or $131?

Mr. REISCHAUER. No. The deficit reduction, the total change, would be $131 billion. The deficit that would result in 1998 would be $228 billion.

Mr. CRANE. So we would get $130 billion reduction——

Mr. REISCHAUER. Reduction from what the deficit would have been otherwise, correct.

Mr. CRANE. Then you mentioned that three-quarters of the $355 billion, this is page 3, in cumulative deficit reduction contained in the administration's program would stem from increases in revenues and only one-quarter from cuts in outlays. By my calculations that brings us down to $32 billion in cuts from outlays. Is that roughly correct? I mean, three-quarters of that $130 billion reduction would be roughly——

Mr. REISCHAUER. I don't have that number, but I think it should be actually over $80 billion. I mean one-quarter of $355.

Mr. CRANE. One-quarter of $355, $80 billion, and the administration's call for tax increases during the timeframe is roughly $250 billion; is that correct?

Mr. REISCHAUER. Yes.

Mr. CRANE. So the difference with that $250 billion increase in taxes is we get roughly $170 billion in reduction, is that——

Mr. REISCHAUER. The reduction in——

Mr. CRANE. No, not that much. If you get——

Mr. REISCHAUER. We would get a reduction in debt that would be equal to the sum of the net deficit reduction. In other words, $355 billion in total debt.

Mr. CRANE. In total debt, but of that, three-quarters only is the reduction from tax increases.

Mr. REISCHAUER. Three-quarters of that would represent increased revenues and one-quarter, as you pointed out, would be lower outlays.

Mr. CRANE. Where is the difference between that three-quarters and the total deficit reduction picture? Is that all in proposed stimulus programs, the outlays that represent the difference.

Mr. REISCHAUER. Well, the outlays are really the net effect of two different things. There is a series of proposals that would reduce spending both in the mandatory and in the discretionary accounts. At the same time, there are a number of increases in spending, which the President has labeled investments, that range from increases in food stamps to more spending on highways, education, and Head Start. So this one-quarter is really the net effect of a quite substantial reduction in spending offset by a quite substantial increase in spending.

Mr. CRANE. OK. That is the thing I am trying to get at. I am not presenting this well, but my bottom line question is, of that $250 billion in increased taxes over 5 years, roughly how much of that goes to deficit reduction in dollar terms and how much doesn't?

Mr. REISCHAUER. It is impossible to allocate the pieces of this the way you would like to allocate them because the money is fungible. Let me give you an example. In 1998, there would be gross spending reductions of $126 billion in the President's proposal, offset by $67 billion of spending increases, and there would also be a net revenue increase of $72 billion, so the summation of these three components amounts to 131 billion dollars' worth of deficit reduction.

Mr. CRANE. OK, that is——

Mr. REISCHAUER. So on balance, spending is going down. There are more decreases than there are increases in that year, and revenues are going up. So both spending and revenues are contributing to that $131 billion reduction in the deficit.

Mr. CRANE. Very good. Thank you, Dr. Reischauer.

Mr. KOPETSKI [presiding]. Dr. Reischauer, thank you very much for your testimony and answering the questions today. You really helped the committee a lot in some of these issues.

We are going to bring forward our first panel, the Honorable Martin Feldstein, professor of economics at Harvard University and also the former Chairman of the Council of Economic Advisers. In addition, Mark Bloomfield, who is president of the American Council for Capital Formation, Thomas Donohue, who is president and chief executive officer of the American Trucking Associations, John J. Motley, vice president for Federal governmental relations, the National Federation of Independent Businesses, and David Gladstone, director, president, Allied Capital, who is with the National Association of Business Development Companies.

I want to alert the committee that Mr. Feldstein has to leave at 1 o'clock, and so hopefully those of you who want to direct questions toward him, might do so early on. I do ask the panel—remind them—that we are operating under the 5-minute rule, that your complete testimony will be made a part of the record. But if you could summarize your testimony in about 5 minutes, the committee would appreciate that.

Mr. Feldstein, welcome.

STATEMENT OF MARTIN FELDSTEIN, PH.D., PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. FELDSTEIN. Thank you very much.

I am going to talk about two things in my testimony. One is the President's deficit reduction plan in general and the second is the specific proposals to raise revenue by higher tax rates and an extension of the HI tax base.

My general conclusion, as I indicate in the prepared statement, is that the President's deficit reduction plan is totally inadequate. It is just not a meaningful deficit reduction package. Contrary to its claim, it would actually leave the full employment deficit substantially higher in 1997 than it is today.

The second broad conclusion is that the President's proposal to raise marginal tax rates would produce little or no additional revenue, but would weaken the economy and waste scarce resources.

Let me look first at the issue of deficit reduction. My analysis indicates that instead of the $140 billion that his plan claimed for 1997, the actual deficit reduction would be less than $50 billion, and that in turn depends upon a variety of favorable assumptions, both about the economy and the ability to control new spending programs. If I am right, the deficit in 1997 would be 3.9 percent of GDP.

By comparison, the CBO has estimated that last year we had a deficit of 3.3 percent of GDP. So under realistic calculations, the deficit as a share of GDP would actually grow substantially larger, substantially worse over the next few years. Why the difference? Let me summarize briefly the reasons for the difference. I will come back to the issue of the effects of failing to take into account adequately the behavioral responses of taxpayers to the higher marginal tax rates and explain why I think in 1997 the administration has overestimated by about $24 billion annual revenue from those changes in tax rules.

In addition, there are the defense outlays. The President has proposed a level of defense spending which would represent a cut in real terms from today's level of spending of 25 percent. That is a $79 billion reduction in 1997 from the current level of spending. I just don't think Congress is going to buy a 25 percent reduction in the real level of spending.

I think the fact that the administration itself has called for maintaining spending on a variety of national security and intelligence matters is an indication of the mood that will eventually determine the size of the defense spending cuts. If defense spending is cut sharply, is cut by 15 percent in real terms from where we are today, we will still find that the defense cuts are $30 billion less than the administration's estimates.

Finally, there is the broad basket of nondefense spending cuts. Even given full credit for all of the administration's estimates about new user charges, increased Medicare premiums and the like, but focusing just on what I describe as a wishful thinking list of management improvements, which while it is easy to write them down, it turns out that year after year we don't see those in practice, I think that just excluding those represents a $30 billion shortfall in deficit reduction.

You put those three pieces together, take into account the impact on debt service costs, and you get a $93 billion difference between the numbers that the administration has written down and the numbers that I think are a realistic estimate for 1997. So I think if you really are serious about deficit reduction, a lot more needs to be done.

Let me turn now to the President's proposed increase in personal tax rates, which is much more directly in the jurisdiction of this committee. I think that the way those tax increases are structured will produce little or no additional revenue. While, of course, because of the very high marginal rates that they imply, they would weaken the economy and would waste scarce investment dollars.

Let me give you an example and ask you to look at a couple of tables that will clarify why this occurs. Remember that for a couple with $180,000 of taxable income, the proposal would jump their marginal tax rates by 25 percent from 31 percent now to 38.9 percent. How are they likely to respond to that? Well, this committee knows all too well that a high income couple could arrange their affairs to easily reduce their taxable income by 5 or 10 percent. Part of that might come from working a little bit less, but it also would come from changing taxable income into untaxed fringe benefits, shifting investments from taxable bonds and high-dividend stocks into municipal bonds and low-dividend stocks, just increasing their mortgage deduction and investing those proceeds in low-taxed securities.

All of that could easily reduce their taxable income by 5 or 10 percent. To see the impact of that, please look at table 1 which is part of the testimony. Table 1 compares what happens to that $180,000 couple—$180,000 of taxable income with no behavioral response and then with two alternative assumptions. You can see with no behavioral response at the top of the table they would pay $2,000 more in individual income tax, that is the extra 5 percentage points on the income between $140,000 and $180,000. They would pay 2.9 percent additional HI tax, on the income between $135,000 and $180,000. So their total increase in their tax bill would be $3,305.

What happens if they have only a 5-percent reduction in their taxable income? Not at all hard to imagine. If they cut their taxable income from $180,000 to $171,000, then the extra 5 percentage points as the tax rate only applies to the income between $140,000 and $171,000 and that produces $1,550 of additional revenue.

But at the same time the fact that they are no longer reporting any taxable income between $171,000 and $180,000 means that the Treasury loses $2,790. Add in the extra HI revenue and the net of it all is a revenue loss of $196. So with only a 5 percent reduction in their taxable income, a de minimis reduction in their taxable income, they will actually pay less in taxes. Since $180,000 represents, according to the Clinton budget document, the halfway mark in incomes over $140,000, half of the taxpayers who would face higher tax rates under the President's plan would actually pay less in taxes if they reduced their taxable income by just 5 percent.

And the bottom part of the table shows what happens if they cut their taxable income by 10 percent. Because the Treasury loses the

existing tax revenue on the difference between the $180,000 and the $162,000—the 10 percent decline—the net of it is that the Treasury would actually lose $3,697.

Now, what does it all add up to in the aggregate? We have done some simulations which are very similar to the ones that you get from the Joint Committee except that we can show you explicitly what the impact is of this kind of behavioral response. I ask you to look at table 2 in the testimony. With no behavioral response, the total tax revenue increase is $26.1 billion. That is very close to the numbers that the administration puts forward; they are not precisely comparable because there are timing differences. Their numbers reflect when the receipts hit the Treasury, ours when the taxpayer accrues the liability, but $26 billion is very, very close to the administration's number. If instead of no behavioral response, taxpayers reduce their taxable incomes by just 10 percent, then we see the number two lines down, $6.6 billion.

In other words, a 10-percent reduction in taxable income would blow away three-quarters of the projected additional revenue. So you end up with a very substantial distortion, much higher marginal tax rates, all kinds of distortions of incentives in the way people invest, the way they save, the way they work, the way they structure their income and out of it you get $7 billion which is about what you would get through a 7 cents a gallon gasoline tax.

These figures have important implications for the budget deficit reduction, for 1994, three quarters of the administration's proposed deficit reduction comes from the higher tax revenues on high income individuals. If we are right about these calculations, and I believe we are, if we are right about them, then most of that goes away.

Instead of $39 billion of deficit reduction in 1994, you get $17 billion, and it also explains why in 1997 I think the administration is overestimating by $24 billion the amount of revenue that would be collected from their plan.

Now, I heard Dr. Reischauer testify to the fact that the Joint Committee staff does take behavior into account, and I want to just end by saying they may do that to a very small extent, but the basic fact is that if you have no behavioral response, the estimated revenue is very, very close to the administration's number. Therefore, there may be some small behavioral response taken into account by the staff, but basically if you ask them to take into account what would happen if taxpayers reduced their taxable incomes by 10 percent, you would see that three-quarters of the projected revenue gains are illusory.

Thank you.

Mr. KOPETSKI. Thank you, Mr. Feldstein.

[The prepared statement and answers to questions subsequently submitted follow:]

[No response to the questions was received.]

Statement of

Martin Feldstein
Professor of Economics, Harvard University

before the

Committee on Ways and Means, U.S. House of Representative
March 16, 1993

Thank you, Mr. Chairman. I am pleased to testify before this committee again today.

I have appeared before you on several occasions over the past decade to advocate tough deficit reduction policies. Unfortunately, the problem is still with us.

I was very pleased therefore by the emphasis that President Clinton put on deficit reduction in his address to the Congress and the nation last month. He spelled out the importance of reducing the government deficit and the resulting borrowing, so that funds can remain in private hands to finance additional business investment that can raise productivity and the future standard of living of the American people.

I was however very disappointed by his specific proposals. After analyzing his plan, I have reached two principal conclusions:

First, the President's deficit reduction plan is totally inadequate. Contrary to its claim, it would actually leave the full-employment deficit substantially higher in 1997 that it is today.

Second, the President's proposal to raise marginal tax rates on high income individuals would produce little or no additional revenue but would weaken the economy and waste scarce investment dollars.

Let me now explain both of these conclusions.

The President's Deficit Reduction Plan

- A realistic analysis of the President's proposals indicates that the actual deficit reduction in 1997 would be less than $50 billion, not the $140 billion that his plan claims. Even that $50 billion estimate depends on several favorable assumptions, including the assumption that the new spending that the President calls "investments and incentives" would be limited to the $55 billion in 1997 that is indicated in the economic plan.

- The resulting deficit would be at least 3.9 percent of GDP, even assuming that the economy is back at full employment in 1997. By comparison, the Congressional Budget Office has estimated that last year's 1992 full employment deficit was only 3.3 percent of GDP. In other words, the deficit problem would grow substantially worse over the next four years.

- A deficit of that magnitude would absorb nearly two-thirds of the private saving in our economy. As a result, the rate of investment would not keep pace with the growth of the labor force, dragging down productivity.

- The national debt is currently more than 50 percent of GDP and that share would still be rising in 1997 under the Clinton plan.

My conclusion that the projected 1997 deficit reduction is realistically at least $90 billion <u>less</u> than the President claims is based on four considerations:

(1) As I will explain in a moment, the **higher marginal tax rates and the elimination of the income ceiling for the Medicare (HI) tax** are likely to produce $24 billion less in tax revenue in 1997 than the economic plan projects.

(2) The President's proposed **defense outlays** for 1997 are 25

percent lower than the outlays needed to maintain today's level of real defense spending. That's a cut of $79 billion in 1997 from the "constant real defense spending" baseline (more than double the $37 billion cut that the President's plan refers to by using a defense baseline that is actually $42 billion less in 1997 than today's real spending level).

I believe that the Congress will not be willing to make such a drastic cut in defense spending at a time of increasing military uncertainty and conflict around the world and a new global proliferation of arms and ballistic missiles. If Congress votes a 15 percent real cut in defense spending over the next four years instead of the 25 percent cut projected by the President, defense outlays will be $30 billion more in 1997 than the Administration plan projects.

(3) Of the $60 billion of projected nondefense "spending cuts" for 1997, nearly $30 billion are for the kind of wishful-thinking management improvements that purport to save money without program reductions or increased user charges. While such projections make budget bottom lines look good, they somehow never happen in practice.

(4) These three adjustments to the President's budget projections add $84 billion to the projected 1997 deficit and smaller amounts to the deficits in the intervening years. The result is a larger national debt in 1997 than the administration forecasts and therefore $9 billion more of debt service costs in 1997.

The result is $93 billion less in deficit reduction in 1997 than the Clinton plan projects. Note that this assumes that all of the revenue projections other than the taxes on high income individuals are accurate and that new spending programs (including the health program that is not even part of the economic plan) do not increase outlays more than the $55 billion projected for 1997.

<u>The Proposed Increases in Personal Tax Rates</u>

- The President's proposal to raise marginal tax rates on high income individuals would produce little or no additional revenue but would weaken the economy and waste scarce investment dollars.

- Consider the effect of the President's proposed tax rate increase on a married couple with $180,000 of taxable income. If they respond to the proposed 25 percent jump in marginal tax rates (from 31 percent today to 38.9 percent including the HI tax under the Clinton plan) by cutting their taxable income by only 5 percent, the Treasury would actually collect <u>less revenue</u> from them under the Clinton plan that it does today.

As members of this Committee know all too well, a high income couple could easily achieve a five percent or ten percent reduction in taxable income by a combination of working a bit less, transforming taxable compensation into untaxed fringe benefits, shifting investments from taxable bonds and high dividend stocks into untaxed municipal bonds or low dividend stocks, increasing their home mortgage interest deduction and investing the borrowed funds in low tax investments, etc..

The attached Table 1 shows how a relatively small behavioral response to the jump in marginal tax rates would actually reduce the couple's tax liability under the Clinton plan relative to their liability under existing tax rates. Instead of the $3,305 of additional tax revenue that would be collected if there were no behavioral response, a five percent reduction in taxable income would reduce the couple's tax payment below what they would pay under current tax rates by $196 while a ten percent reduction in taxable income would reduce the couple's tax payment by $3,697.

- Since half of the taxpayers with incomes over $140,000 have incomes below the $180,000 level used in this example, this example shows that even a 5 percent reduction in taxable income would mean that <u>the majority of taxpayers who would face higher tax rates under the Clinton plan would actually pay less tax than they do under the current tax law.</u>

- These examples indicate the importance of taking the behavioral response of taxpayers into account in evaluating the revenue effects of the President's proposed tax increases. I have now done this in collaboration with Dr. Daniel Feenberg, a colleague at the National Bureau of Economic Research (NBER). Our study is based on a computerized sample of almost 100,000 anonymous individual tax returns.

The computer simulation model that we use (the NBER's TAXSIM model) provides estimates similar to those produced by the staffs of the Treasury and the Joint Tax Committee and can also be modified to show the effects of alternative assumptions about how taxpayers respond to changes in tax rates and tax rules.

- The NBER study is described in a report that is attached to this testimony and that will be published in the March 22nd issue of Tax Notes ("Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan").

Our simulation analysis indicates that the higher tax rates and the expanded Medicare tax base in the President's plan would raise taxes by a total of $26 billion a year (at 1993 levels) if taxpayers do not respond to the sharp rise in marginal tax rates. This figure is consistent with the revenue estimate made by the Clinton Administration.

But the assumption that taxpayers do not change their behavior when confronted with marginal tax rates that are 25 percent higher than they are today (or 37 percent for those with incomes over $250,000) is clearly wrong. If these substantial increases in marginal tax rates cause taxpayers to reduce their taxable incomes by just 10 percent, the additional revenue collected by the Treasury would be less than $7 billion a year.

These figures are shown in Table 2 which distinguishes between the effect on total revenue (column 2) and the effect on revenue excluding the HI tax. (column 1).

These calculations make no allowance for the adverse effect on tax revenue of the slower pace of economic recovery that is likely to result from the Clinton plan.

These adjusted revenue estimates have important implications for the Administration's deficit projections.

- The Administration projects a net deficit reduction of $39 billion in 1994, of which more than $30 billion is projected to come from the higher tax rates on high income individuals. Correcting only the Administration's estimate of the likely increase in the tax revenue reduces the 1994 deficit reduction from $39 billion to only $17 billion.

- Applying this analysis to 1997 implies that the Administration's projection of $33 billion of additional revenue from higher tax rates on high income taxpayers should be reduced to $9 billion. The $24 billion difference between $33 billion and $9 billion is the amount that I referred to earlier in this testimony in my analysis of the President's deficit projections for 1997.

- The NBER report also reviews evidence on how taxpayers responded to the tax rate reduction in the early 1980s. If taxpayers are even half as sensitive to the proposed Clinton tax rate hikes as they were when rates were cut in the early 1980s, the additional revenue raised by the Clinton plan would be even less than the projections based on a ten percent reduction in taxable income.

The final row of Table 2 shows the effect on tax revenue if taxpayers are just half as sensitive to the increased tax rates as they were when rates were cut in the early 1980s. Those with incomes between $140,000 and $250,000 would reduce their taxable incomes by 9 percent but those with incomes over $250,000 (whose marginal tax rates would rise by 37 percent) would reduce their taxable incomes by 13 percent. The result would be a net revenue gain to the Treasury of only $3.6 billion a year, essentially all of which would come from the higher HI tax collections and none from higher individual income tax collections.

Because the sharp rise in marginal tax rates would distort taxpayers' decisions about work and saving and personal investments, it would cause a significant waste of resources and would reduce real incomes in the economy.

In my judgement, the NBER study shows that these harmful effects of higher marginal tax rates cannot be justified by any corresponding gain in deficit reduction.

The President's budget and tax plan were prepared in haste and without the help of the necessary staff that had not yet been appointed. I hope that the Congress will reject the President's proposal and that you will use the expertise of this Committee to cut future deficits by reducing spending on programs that are within the Committee's jurisdiction and by raising revenue in ways that are far less damaging than the President's proposal.

(Two tables follow this text.)

Table 1

Effects of Reductions in Taxable Income on Tax Liabilites of a Married Couple with $180,000 of Taxable Income

The following analysis shows how President Clinton's proposed increase in personal tax rates and of the HI tax base would affect the taxes paid by a married couple with $180,000 of taxable income under three alternative assumptions about their response.

	REVENUE CHANGE
Revenue Effect with No Behavioral Response	
Individual Income Tax: Income tax rates rise from 31 % to 36 % on the $40,000 of taxable income between $140,000 and $180,000	+ 2,000
HI Tax: The 2.9 percent HI tax rate is applied to income between $135,000 and $180,000.	+ 1,305
Net Revenue Effect	+ 3,305
Revenue Effect with 5 Percent Induced Decline in Taxable Income to $171,000	
Individual Income Tax:	
Income tax rates rise from 31 % to 36 % on the $31,000 of taxable income between $140,000 and $171,000	+ 1,550
No income tax collected at 31 % on the $9,000 of previously taxed income between $171,000 and $180,000	- 2,790
HI Tax: The 2.9 percent HI tax rate os applied to income btrween $135,000 amd $171,000	+ 1,044
Net Revenue Effect	- 196
Revenue Effect with 10 Percent Induced Decline in Taxable Income to $162,000	
Individual Income Tax:	
Income tax rates rise from 31 % to 36 % on the $22,000 of taxable income between $140,000 and $162,000	+ 1,100
No income tax collected at 31 % on the $18,000 of previously taxed income between $162,000 and $180,000	- 5,580
HI Tax: The 2.9 percent HI tax rate is applied to income berween $135,000 amd $162,000	+ 783
Net Revenue Effect	- 3,697

Testimony of Martin Feldstein, Ways and Means Committee, March 16, 1993.

Table 2

Aggregate Revenue Effects of the Clinton Plan: Implications of Alternative Behavioral Responses

	Projected change in	
	Personal Income Tax Revenue ($ billions)	Total Tax Revenue ($ billions)
No Behavioral Response	21.8	26.1
5 percent reduction in taxable incomes	12.2	16.1
10 percent reduction in taxable incomes	3.0	6.6
15 percent reduction in taxable incomes	-5.7	-2.5
9 percent reduction in taxable incomes below $250,000 and 13 percent reduction in taxable incomes above $250,000.	0.1	3.6

Source: NBER TAXSIM calculations reported in Martin Feldstein and Daniel Feenberg, "Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan," (To be published in Tax Notes, March 22, 1993.)

These projections are estimates of changes in tax liabilities at 1993 income levels. The "total tax revenue" projections include the 2.9 percent HI tax on incomes above $135,000. The analysis deals only with the proposed increase in individual income tax rates and in the HI tax base and does not reflect the proposed changes in the taxation of Social Security benefits, in the alternative minimum tax and in other tax rules.

Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan

Martin Feldstein and Daniel Feenberg*

This report analyzes the revenue effects of President Clinton's February 17th proposal to raise individual income tax rates and to remove the income ceiling from the Medicare (HI) payroll tax.

The principal finding of this analysis is that if taxpayers reduce their taxable incomes by a quite small percentage in response to the substantial increases in marginal tax rates, the resulting declines in taxable income would eliminate most and possibly all of the additional tax revenue projected by the Administration. The amount of additional revenue estimated by the Administration could only occur if taxpayers do not respond in any significant way to the proposed sharp rise in marginal tax rates.

More specifically, the simulations presented in this paper, which are based on the TAXSIM model of the National Bureau of Economic Research, show that the proposed increases in personal taxes would raise approximately $26 billion a year in additional tax revenue if there is no change in taxpayer behavior but less than $7 billion a year if taxpayers respond to the higher tax rates by reducing their taxable incomes -- through less work and through explicit tax avoidance strategies -- by just ten percent.

In all likelihood, there is relatively little revenue gain and therefore relatively little potential budget deficit reduction to justify the substantial disincentives and distortions that result from the much higher marginal tax rates that have been proposed. Moreover, since three-fourths of the deficit reduction projected by the Clinton Administration for fiscal year 1994 is assumed to come from these higher marginal tax rates on high income individuals, the present study also casts substantial doubt on the projected reduction of the fiscal deficit.

These calculations make no allowance for the adverse effects on tax revenue of the slower pace of economic recovery that is likely to result from the Clinton plan. They reflect only individual taxpayer decisions to reduce taxable income and not any change in aggregate demand.

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*This report was prepared as part of the Tax Research Project of the National Bureau of Economic Research. Martin Feldstein is President of the NBER and Professor of Economics at Harvard University. Daniel Feenberg is a Research Associate of the NBER. (March 14, 1993)

The President's Personal Tax Proposal

The key feature of the Clinton proposal on personal taxation is to raise the tax rate on taxable incomes over $140,000 from 31 percent to 36 percent.[1] For taxpayers with taxable incomes over $250,000, the 36 percent is raised to 39.6 percent by a 10 percent surcharge on the taxes paid on taxable incomes over $250,000. In addition, the Medicare payroll tax of 2.9 percent on employers and employees would no longer be limited to $135,000 of income but would apply without limit to incomes above that amount.

The basic effect of these proposed changes would be to raise the marginal tax rate from 31 percent to 38.9 percent for taxpayers with incomes between $140,000 and $250,000 and from 31 percent to 42.5 percent (the 31 percent marginal personal income tax rate is raised to 39.6 percent with the surcharge and to 42.5 percent by the HI tax). In actual practice, the effect would be more complex because of several features of the existing tax law including the

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[1]This figure is for married couples filing joint returns. The corresponding figure for single taxpayers is $115,000. To simplify the discussion in the text of this report, we refer only to the tax situation and incomes of married couples but our statistical analysis deals with single as well as married taxpayers.

income-related reduction of itemized deductions and the alternative minimum tax; these complexities are taken into account in the simulations discussed below. The President's tax proposal also includes other features that would raise the tax on high income individuals (the increased share of Social Security benefits to be included in taxable income, the reduced deduction for entertainment expenses, etc.) that are not included in the present analysis.

The sharp increase in marginal tax rates would induce many taxpayers to reduce their taxable incomes. This reduction in taxable incomes could be achieved in a variety of ways.

The most direct way for a taxpayer to reduce taxable income in response to the substantially higher marginal tax rates would be by working less. That option is likely to be much more available to these high incomes taxpayers, many of whom are self-employed or receive compensation tied to performance, than it is to the population as a whole. In addition, a substantial body of research confirms that two-earner households are more sensitive to marginal tax rates than single-earner households.

Taxpayers can also convert taxable investment income into untaxed income (municipal bonds) or into income taxed at the much lower effective tax rates on deferred capital gains. Increasing tax deductions by adding to home mortgages, by greater borrowing to finance portfolio investments, and by increased charitable contributions also reduces taxable income. Taxable incomes can also be reduced in response to higher marginal tax rates by employer policies that convert currently taxable compensation into untaxed forms (e.g, first class travel and accommodations, corporate health and fitness facilities, other fringe benefits, etc.).

Our simulations calculate the effect of President Clinton's proposed increases in personal tax rates and in the HI tax base conditional on several alternative assumptions about taxpayers' responses. We begin with the "no behavioral response" assumption that has been the traditional method of the staffs of the Treasury and the Joint Tax Committee. We then calculate the revenue gains if taxpayers respond to the higher tax rates by reducing taxable income by three alternative amounts (5 percent, 10 percent, and 15 percent). Finally, we use the responses of taxpayers to the tax rate reductions in the early 1980s as a basis for estimating the responses of taxpayers to the proposed rate increases.

Two Representative Examples

An analysis of two representative high income taxpayers shows how even relatively modest declines in taxable income in response to the large jumps in marginal tax rates can result in the loss of most or all of the additional tax revenue that would result from the higher tax rates if there were no behavioral response.

Consider first a couple with taxable income of $180,000, the level of income that the Clinton plan identifies as the median taxpayer among those with incomes above the $140,000 threshold. With no behavioral response to the higher marginal tax rates, the proposed tax changes would raise $2000 of additional personal income tax (5 percent of the $40,000 of income between $140,000 and $180,000) and $1305 of additional HI tax (2.9 percent of the $45,000 of income between $135,000 and $180,000)[2] for a total revenue gain by the Treasury of $3,305. If, however, the couple responds to the 25 percent rise in their marginal tax rate (i.e., the rise from 31 percent to 38.9 percent) by reducing their taxable income by just 5 percent from $180,000 to $171,000, the Treasury would actually lose money. This revenue loss occurs because the $9,000 reduction in taxable income (from $180,000 to $171,000) reduces current revenue by $2790 (at the 31 percent existing marginal tax rate) while the 5 percent increase in the personal tax rate on the $31,000 (between $140,000 and $171,000) raises only $1550 in revenue and the 2.9 percent HI tax on the $36,000 (between $135,000 and $171,000) raises only $1044 for a total of $2594. The difference between the $2790 revenue loss and the $2594 revenue

[2]This assumes that there is a full $45,000 of wage and salary income in excess of $135,000 per individual. If the married couple contained two wage earners and each had less than $135,000 of income subject to the HI tax, the proposed extension of the HI tax base would not raise any additional revenue.

gain implies a net loss to the Treasury of $196 for this representative high income taxpayer.[3]

A similar calculation for any taxpayer with income between $140,000 and $180,000 would also show a revenue loss in response to a 5 percent reduction in taxable income. Since half of all taxpayers who would face higher marginal tax rates under the Clinton plan have incomes between $140,000 and $180,000, it follows that more than half of those taxpayers who face higher marginal tax rates would actually pay less tax under the Clinton plan than under the current tax law if they reduce their taxable incomes by as little as five percent in response to the jump in their marginal tax rates.

If the higher tax rates proposed in the Clinton plan caused a couple with $180,000 of taxable income to reduce its taxable income by 10 percent, the Treasury would actually lose $3,697 instead of gaining the $3,305 that would result if there were no behavioral response. This revenue loss occurs because the Treasury would lose $5,580 on the reduced taxable income (31 percent of $18,000) but would only gain $1,100 in higher personal income tax (5 percent of the $22,000 between $140,000 and $162,000) and $ 783 in greater HI tax (2.9 percent of the $27,000 between $135,000 and $162,000).

For a second representative high income taxpayer, consider a couple with $400,000 of taxable income. Because their taxable income is more than $250,000, their marginal tax rate would include an additional 3.6 percentage points that results from the 10 percent "surcharge," bringing the total marginal tax rate to 42.5 percent. With no behavioral response, this couple would pay $26,085 more in tax under the Clinton plan than under existing tax law. But if the 37 percent jump in the marginal tax rate caused the couple to reduce their taxable income by 10 percent, the revenue rise would be only $9085. Looking just at the personal income tax, the rise in the rate from the current 31 percent to 39.6 percent (including the "surcharge") would raise $18,400 if there is no behavioral response but only $2,560 if these taxpayers reduce their taxable income by ten percent.

The higher tax rates produce little or no additional revenue because there is no increase in tax rates on the first $140,000 of income. A relatively small reduction in total taxable income therefore represents a substantial proportional reduction in the part of income that is to be taxed at a higher rate. Moreover, the taxable income that has been eliminated would have been taxed at a rate that was high (31 percent) relative to the increase in the tax rate (7.9 percent without the surcharge and 11.5 percent with the surcharge).

It is the structure of the tax increase, rather than the final tax rate or the degree of taxpayer responsiveness, that causes the loss of revenue. To see this, note that increasing a <u>proportional</u> income tax from 31 percent to 38.9 percent would raise substantial revenue even if taxpayers reduced their taxable income by the five percent assumed in the above calculations. More specifically, if a taxpayer with $180,000 of taxable income now paid 31 percent on <u>all</u> of that income (a tax of $55,800), an increase in that tax rate to 38.9 percent would increase revenue to $70,020 with no behavioral response and to $66,519 if taxpayers reduced their taxable incomes by five percent to $171,000.

<u>Aggregate Revenue Effects: The NBER TAXSIM Analysis</u>

We have used the NBER TAXSIM model to estimate the aggregate revenue effects of the proposed changes in the personal income tax rates and in the HI tax base. The TAXSIM model uses a stratified random sample of almost 100,000 individual tax returns provided by the Internal Revenue Service. These data for 1989 are then adjusted to estimated 1993 income levels. The TAXSIM model can thus estimate the revenue effects of alternative tax rules in a way that is very similar to that used by the Treasury Department and by the staff of

[3] If the couple does not face any increase in HI tax because each had wage and salary income of less than $135,000, the Treasury would lose money if, in response to the rise in the marginal tax rate from 31 percent to 36 percent, the couple reduced their taxable income by just $5,000 or less than three percent of the initial taxable income.

the Joint Tax Committee. The TAXSIM model can also reflect a variety of behavioral responses to changes in tax rules and tax rates.

To calculate the effect of the proposed higher tax rates on personal income tax liabilities, the TAXSIM analysis incorporates current tax law and changes only the tax rates for high income single and married taxpayers according to the schedules in the Clinton proposal. The resulting marginal tax rates are actually somewhat higher than that those described above because of the current tax rule disallowing itemized deductions equal to three percent of income above a minimum level. This raises the current top marginal rate from 31 percent to an effective marginal tax rate of 31.9 percent and interacts with the Clinton proposed rate increases and makes the top marginal tax rate nearly 44 percent. The higher tax rates implied by the Clinton plan would also cause some taxpayers who currently pay the alternative minimum tax to pay the regular income tax instead.

The TAXSIM model has been modified to reflect the extension of the 2.9 percent payroll tax to incomes above $135,000. To calculate the increase in the HI tax base for each tax return, we use a statistical method to divide the wage and salary income (from line 1 of form 1040) between the two spouses in a way that reproduces the relation between spouses' incomes in the 1989 Current Population Survey. In addition to this wage and salary income, the HI tax is applied to all positive Schedule C income and to all of the partnership and Subchapter S corporate incomes of tax returns reporting positive net income from this source.

The behavioral response for each individual is constrained in our analysis to keep the taxable income over $140,000 since any lower level of income would return the taxpayer to the original marginal tax rate. For example, a couple with income of $145,000 would not reduce their taxable income by the full five percent (to $138,000) but only to the $140,000 level.

With no behavioral response, the TAXSIM model implies that the Clinton plan would raise tax liabilities by $25.8 billion at 1993 income levels, including $21.5 billion of additional personal income taxes and $4.3 billion of additional HI taxes. Table 1 shows the effect of alternative behavioral responses on the projected tax revenues.

These estimated increases in personal taxes cannot be compared directly with the Administration's 1993 revenue estimates presented in A Vision of Change for America because the Administration's estimates are intended to reflect amounts collected by the Treasury while our figures are estimates of tax liabilities that may be paid with a lag, especially during the first year of the higher tax rates. The Administration shows only $1.8 billion in Treasury tax receipts from this source in fiscal year 1993 but then $27.7 billion in FY1994 and $19.9 billion in FY1995. Our estimate of $21.5 billion of increased tax liabilities for 1993 thus seems consistent with the Administration's projections for the next several years.

Our no behavioral response estimate of $4.3 billion of additional HI tax revenue is also broadly consistent with the Administration's estimates of additional revenue from this source. The Administration shows no revenue from this source for 1993 but a fully-phased-in level of $6.0 billion in fiscal year 1995 which then rises at a rate of $400 million a year. That annual rate of change suggests that the Administration's "fully phased in" level of additional HI taxes would be $5.2 billion in 1992. Given the great difficulty in estimating this number (associated with the problems of separating nonlabor income from labor income in the statistics on partnerships and Subchapter S corporations), this $5.2 billion is close to the $4.3 billion that we estimated.

The next three lines of Table 1 present the effects of 5, 10 and 15 percent reductions in taxable income. The 10 percent behavioral response implies that the Treasury would collect only about one-forth of the revenue that would be collected if taxpayers did not respond at all: $6.8 billion of additional revenue instead of the $25.8 billion projected with no behavioral response. Even

Table 1

Revenue Effects of the Clinton Tax Plan:
Implications of Alternative Behavioral Responses

	Projected change in Personal Income Tax Revenue ($ billions)	Total Tax Revenue ($ billions)
No Behavioral Response	21.8	26.1
5 percent reduction in taxable incomes	12.2	16.1
10 percent reduction in taxable incomes	3.0	6.6
15 percent reduction in taxable incomes	-5.7	-2.5
9 percent reduction in taxable incomes below $250,000 and 13 percent reduction in taxable incomes above $250,000.	0.1	3.6

Source: NBER TAXSIM calculations.

These projections are estimates of changes in tax liabilities at 1993 income levels. The "total tax revenue" projections include the 2.9 percent HI tax on incomes above $135,000. The analysis deals only with the proposed increase in individual income tax rates and in the HI tax base and does not reflect the proposed changes in the taxation of Social Security benefits, in the alternative minimum tax and in other tax rules.

more striking, the increased revenue from the individual income tax would be less than one sixth of the revenue that is projected on the assumption that taxpayers do not respond to the higher marginal tax rates: $3.2 billion of additional personal income tax revenue instead of the $21.5 billion that corresponds to no behavioral response.

Comparing these figures with the corresponding estimates for the five percent and 15 percent reductions in taxable income shows that each one percent induced reduction in taxable income lowers the estimated total revenue by nearly $2 billion.

Earlier statistical research by Lawrence Lindsey[4] based on taxpayer responses to the 1981 tax legislation provides some evidence on how high-income taxpayers might respond to the current proposed changes. Lindsey found that each one percent increase in the marginal after-tax share of income that a taxpayer could retain raised the taxpayer's taxable income by between 1.6 percent and 1.8 percent. Allowing the responsiveness to vary with the taxpayer's income level resulted in estimates the each one percent increase in the marginal after-tax share of income raised the taxpayer's taxable income by 1.0 percent for taxpayers with incomes of

[4]See Lawrence Lindsey, "Individual Taxpayers Responses to Tax Cuts:1982-1984," Journal of Public Economics, 1987, pp. 173-206.

$100,000, by 1.4 percent for taxpayers with incomes of $250,000 and by 2.0 percent for taxpayers with incomes of $1 million.

These estimated responses my overstate the induced changes in taxable income and in tax revenues that are likely in the current context. Some of the tax shelter opportunities that were used by high income taxpayers in the early 1980s are no longer available because of the Tax Reform Act of 1986. Moreover, part of the higher proposed marginal tax rate is the 2.9 percent HI payroll tax. This portion of the increased marginal tax rate produces an incentive to earn less and to convert earned income into untaxed income but does not provide any incentive to increase deductions or to change the form of investment income. To the extent that the reduced taxable income does not lower income subject to the HI tax, the revenue impact of the reduction in taxable income would be smaller.

To be very conservative, we have replaced the Lindsey estimates that each one percent increase in the marginal net income share raises taxable income by about 1.6 percent with a responsiveness of only half that value, i.e. a response of only a 0.8 percent rise in taxable income for each one percent rise in the marginal net income share.

Applying this in the current context, a rise in the taxpayer's marginal tax rate from 31 percent to 38.9 percent is equivalent to a 11.4 percent decline in the marginal net income share (i.e., the net-of-tax income share declines by 7.9 percentage points which is 11.4 percent of the initial 69 percent net income share). Combining this 11.4 percent decline in the marginal net income share with the 0.8 percent responsiveness implies that a taxpayer faced with this decline in the net of tax share would reduce taxable income by 9.1 percent.

For the higher income taxpayers whose marginal tax rates would rise from 31 percent to 42.5 percent, the marginal net income share would fall by 16.7 percent (i.e., the net income share declines by 11.5 percentage points which is 16.7 percent of the initial 69 percent net income share.) A responsiveness of 0.8 implies a 13.3 percent decline in taxable income for this group.

Using these parameter estimates -- a 9 percent reduction in taxable income for taxpayers with initial taxable incomes under $250,000 and a 13 percent reduction in taxable incomes for taxpayers with incomes under $250,000 -- implies that the proposed increase in tax rates and in the HI tax base would increase total revenue by only $4.0 billion rather than the 25.8 billion that would result if there were no taxpayer response. Essentially all of the additional revenue would come from the greater HI tax collection. The total personal income tax revenue would rise by less than $500 million, about one-tenth of one percent of the personal tax revenue that would be collected with no change in tax rates.

Conclusion

The fundamental conclusion of this analysis is that a relatively small response of taxpayers to the very substantial proposed rise in marginal tax rates would eliminate most and possibly all of the increased tax revenue projected by the Administration.

The distortions in labor supply, in personal investment decisions, in the forms of compensation, and in activities designed to create tax deductions and tax losses all lead to a waste of real economic resources and therefore to lower real incomes.[5] Recognition of these adverse effects of high marginal tax rates led to the bipartisan support for the Tax Reform Act of 1986 which reduced marginal tax rates and broadened the tax base. The experience since 1986 has shown that the lower tax rates led to substantial increases in taxable incomes, particularly among very

[5] Since the "deadweight loss" or "excess burden" caused by distortionary taxes is proportional to the square of the marginal tax rate, an increase in the marginal tax rate from 31 percent to 38.9 percent would increase the deadweight loss by 57 percent while an increase in the marginal tax rate from 31 percent to 42.5 percent would increase the deadweight loss by 88 percent.

high income individuals.

A return to the high marginal tax rates proposed by Presdient Clinton might possibly be justified if they were accompanied by substantial increases in tax revenue that would be used to reduce the large budget deficits. But the analysis and simulations presented in this report make it clear that the structure of the proposed increases in tax rates would lead to very little if any such additional revenue. The proposal to raise marginal tax rates sharply would thus impose a significant burden on the economy without any corresponding gain in deficit reduction.

March 10, 1993.

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[6] See Daniel Feenberg and James Poterba, "Income Inequality and the Incomes of Very High Income Taxpayers: Evidence from Tax Returns," NBER Working Paper 4229 (December 1992), forthcoming in Tax Policy and the Economy (MIT Press, 1993).

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COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515-6348

April 14, 1993

Martin Feldstein, Ph.D.
National Bureau of Economic Research
1050 Massachusetts Avenue
Cambridge, Massachusetts 02138

Dear Dr. Feldstein:

Thank you for your testimony on March 16 at the Committee on Ways and Means' public hearing on President Clinton's economic and deficit reduction plan. Unfortunately, because of your tight schedule and early departure, Members of the Committee missed the opportunity to inquire of you about several subjects of interest to them.

I am specifically interested in your remarks about the Administration's proposed increase in marginal tax rates of high-income individuals. You testified that these would "raise little or no additional revenue" and you referred to them as "damaging." Would you please provide responses to the enclosed questions for the formal hearing record?

Thank you, Dr. Feldstein, for taking the time to testify before the Committee and to respond to these questions. Your answers will be helpful to the Committee on Ways and Means as we review the Administration's tax proposals and other economic initiatives. It would be most helpful to us if we received your response for the record by April 26, 1993.

Sincerely yours,

Dan Rostenkowski
Chairman

DR:kocc

Enclosure

QUESTIONS FOR DR. FELDSTEIN

1. You concluded your testimony by urging the Committee to reduce the deficit through spending cuts or through revenue increases that are "less damaging" than the President's proposals. What specific spending cuts and revenue increases do you advocate? Since you state on page 5 of the report that accompanied your testimony that the revenue loss you predict results from the progressive structure of the income tax, would you support an across-the-board increase in income tax rates?

2. What types of behavioral responses do you expect to result in the reduction in taxable income discussed in the report? How large, in elasticity terms, are these expected responses? What percentages of the declines in taxable income you predict are the result of decreases in labor supply, increases in itemized deduction, shifting of income to untaxed sources, shifting of income into capital gain producing assets, or other behavioral responses?

3. If you used the same methodology to look at the revenue effects of increasing the high-end marginal tax rates in the Omnibus Budget Reconciliation Act of 1990, how would your predicted effects compare with what was observed?

4. A significant part of the increase in marginal rates in the Administration's proposal is due to the proposed increase in the base of the Medicare (HI) tax. Since you acknowledge on page 8 of your report that this tax is harder to avoid than the income tax, why does your analysis not distinguish between the response of HI-taxable wages and that of taxable income?

5. In your examples, you assume that the Medicare (HI) tax applies only to the first $135,000 of a household's earnings under current law. As noted in footnote 2 of your report with Daniel Feenberg, this is true only for a single-earner household. How many households in this income range are single-earner households?

6. Table 1 in your testimony may miscalculate the amount of tax revenue of the HI tax under your "no behavioral response" case. The HI tax applies to wage income, not taxable income. A couple with $180,000 of taxable income would have a higher amount of gross income. In the cases you show to illustrate given behavioral responses, you assume that the decline in taxable income consists entirely of wage decreases. What assumption did you use in your simulations?

7. Do you take into account the alternative minimum tax in your simulations? To what extent will taxpayers who reduce their taxable income by taking increased deductions be subjected to the AMT?

STATEMENT OF MARK BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. KOPETSKI. Welcome, Mr. Bloomfield. When that red light goes on, that means the 5 minutes have expired.

Mr. BLOOMFIELD. Mr. Chairman, members of the committee, my name is Mark Bloomfield, I am president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our chief economist. We very much appreciate the opportunity to present testimony on the capital formation impact of the tax elements of the administration's economic proposal.

The ACCF represents a broad cross-section of the American business community, including the manufacturing and investments sectors, Fortune 500 companies, and smaller firms, and individual investors. Our board of directors includes Cabinet members of prior Democratic and Republican administrations, former Members of Congress, prominent business leaders, and public finance experts. Our affiliated public policy think tank has commissioned extensive economic research in the past several years which we believe is pertinent to this subject today.

Our frame of reference is the impact of the tax package as a whole as well as specific elements, the investment tax credit, alternative minimum tax, capital gains taxes, energy taxes, and the increases in individual and corporate tax rates on saving and investment in the U.S. economy. As a predicate to discussion of the President's tax proposals, I would like to say a few words about the level of investment in the United States and the impact of tax policy.

First, as Secretary Bentsen last week documented to this committee, U.S. annual private investment as percentage of GDP has persistently over the last 12 years lagged behind our competitors. Second, recent research shows that the volume of investment in equipment, and I stress equipment, is a critical factor in the pace of economic growth and development. In their research, Harvard professors Larry Summers, now Treasury Under Secretary-designate for International Affairs, and Brad De Long conclude that for a broad cross-section of countries, every 1 percent of GDP that is invested in equipment is associated with an increase in the GDP growth rate itself of one-third of 1 percent—a very substantial rate of return.

And third, although the Tax Reform Act of 1986 substantially reduced corporate and individual income tax rates, the legislation also raised effective tax rates on the equipment I just mentioned through the repeal of the investment tax credit, lengthening of capital cost recovery periods and enactment of the alternative minimum tax and higher tax rates on capital gains. Analysis by Arthur Andersen & Co. shows that for equipment that is technologically innovative or crucial to U.S. economic strength, our capital cost recovery lags badly behind our major competitors.

With that background, Mr. Chairman, let's now turn to the President's proposal. Two major questions emerge with respect to the impact of President Clinton's plan on private capital formation. First, will it raise the national saving rate? Second, will it increase the proclivity of decisionmakers in business to step up productive investment rather than use available funds for other purposes?

First on the savings side, the promise of the President's plan depends on deficit reduction that would free up saving for capital formation, other things being equal. Other things, as Professor Feldstein pointed out, however, are not equal. The administration's proposal contains individual tax increases that are heavily tilted toward upper-income groups. Many such taxpayers will maintain their levels of consumption, or reduce them only slightly and in effect pay the higher taxes by reducing savings. Business' ability to save through retained after-tax earnings will be reduced by the increase in the corporate tax rate, the new energy tax and the various provisions that on balance combine to raise the business tax burden.

Second on the investment side, very little of the investment identified in the Clinton plan will be in the form of capital outlays in the private sector. A positive factor is the permanent extension of the R&D credit. The alternative minimum tax reform is a step in the right direction, but unfortunately, minimal on its impact in relieving the heavy taxation of investment. The two proposed investment tax credits will do little to promote investment in the productive equipment that is so crucial to growth. The President is correct in proposing a capital gains tax cut, but the measure should be expanded in order to have a significant impact on the cost of capital. A negative impact is the proposed Btu tax on energy which is likely to affect U.S. economic growth adversely.

The President rightly asks: If you have concerns with the administration's proposal, suggest a fiscally responsible and proinvestment alternative. We believe a broad-based consumption tax, such as a value-added tax, is preferable to the increase in energy taxes in the Clinton proposal. Furthermore, we advocate restructuring the U.S. tax system so as to reduce the heavy penalty on saving and investment inherent in income tax. Revenue from a U.S. consumption tax could be used to reduce the deficit and finance tax reform, including incremental measures such as the investment tax credit, reform of the alternative minimum tax, environmental investment which is heavily penalized in our country compared to our competitors, restoration of a capital gains differential, and more liberal IRAs. If spending were restrained, as the President has proposed, the revenue from such a tax would also reduce Federal dissaving, lower real interest rates, cut capital costs, and make the United States more competitive.

In conclusion, Mr. Chairman, as Secretary Bentsen said to this committee last week, "Deficit reduction will make an important contribution to long-term economic growth." But the Secretary added, "We need to take action to create jobs and to stimulate investment." We can't do it with the existing tax system. We can't get there with incremental steps. We need to be bolder. The consumption tax alternative with adequate safeguards for lower income Americans can get us there.

Thank you.

Mr. KOPETSKI. Thank you.

[The prepared statement and attachments follow:]

Statement of
Mark Bloomfield, President
American Council for Capital Formation
before the House Ways and Means Committee

March 16, 1993

Introduction

My name is Mark Bloomfield. I am President of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our chief economist. We appreciate the opportunity to present testimony on the impact of the tax elements of the Administration's economic proposal on capital formation, the effect of specific tax proposals on saving and investment, and the feasibility of an alternative revenue option to reduce the deficit and promote economic growth.

The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, associations, individuals, and investors. Our board of directors includes cabinet members of prior Democratic and Republican administrations, former members of Congress, prominent business leaders, and public finance experts. Our affiliated public policy think tank, the ACCF Center for Policy Research, has commissioned extensive economic research in the past several years as part of its multi-year project, *Tax and Environmental Policies and U.S. Economic Growth,* which we believe is pertinent to the subject of today's hearing.

In order to analyze the economic impact of the Administration's proposal and to weigh alternative approaches, it is imperative to set forth a standard against which to judge the tax initiatives the President has asked the Committee to consider. Our frame of reference is the impact of the tax package as a whole as well as specific elements--the investment tax credit, the alternative minimum tax, capital gains taxes, energy taxes, and the increases in the individual and corporate tax rates--on saving and investment in the U.S. economy.

President Clinton, in the campaign and since his first weeks in office, has done a remarkably good job of articulating the fundamental economic difficulties we need to overcome and the basic choices the country faces to accomplish that task. He is to be applauded for his political leadership in moving forward expeditiously and courageously with his economic plan and in mobilizing public support behind it. The promise of the President's package depends to a very large extent on reduction of the federal deficit as a percentage of gross domestic product (GDP) from about 5 percent to nearly half that level over the next five years, thereby significantly increasing our national saving and private investment and putting us on the road to solid economic growth.

Much of the ability to deliver on this promise depends on what Congress does on the spending side--making sure that the spending cuts are real, that the ratio of spending cuts to tax increases does not erode, and that enforcement of spending cuts becomes a reality rather than a promise. However, the Committee's agenda today is to focus on the tax component of the package and in particular, on the impact of the proposals on saving and investment, competitiveness, and economic growth--which is our area of expertise. To put it succinctly, one can reduce the federal deficit by increasing taxes on private saving and investment or by enacting alternative tax measures that do not impede the saving and investment so critical for long-term economic growth. To pursue the latter is our challenge.

Factors Influencing Economic Growth

As a predicate to our discussion of the tax components of the President's economic package, there are several major factors that influence economic growth that I would like to bring to the attention of the Ways and Means Committee.

- <u>U.S. Saving and Investment Too Low</u>

Investment spending in the United States in recent years compares unfavorably with that of other nations and our own past experience. From 1973 to 1990 saving and investment as a percent of GDP was lower for the United States than for any of our major competitors with the exception of the United Kingdom (see Table 1). Further, U.S. annual net private domestic investment is currently averaging less than 2 percent, compared to 6.9 percent over the 1960-1981 period.

A comparison with Japan is illustrative of our investment disadvantage in the very competitive global economy today. Japan's lead in saving and investment is highlighted by a comparison over the 1973-1990 period. Over that time period, Japan invested a much larger portion, 30.1 percent, of its GDP in plant and equipment, as contrasted with only 17.8 percent in the United States (see Table 1). Even more disturbing is the fact that Japan, whose GDP is just over half that of the United States, is investing more in absolute dollar amounts than is the United States and invests twice as much per worker. In 1990, Japan's nonresidential fixed investment equalled $675 billion, while the comparable figure in the U.S. was only $524 billion.

Those who argue that U.S. investment in productive equipment has held up well after the passage of the Tax Reform Act of 1986 (TRA) need to look at the data before and after the 1986 legislation. For example, producers' durable equipment is growing at a rate of less than 9 percent during the economic recovery that began in the second quarter of 1992, compared to over 16 percent during the previous recovery that began in 1982 (see Table 2). Furthermore, disaggregating the data on investment in producers' durable equipment reveals some troubling information. Few will dispute the gain in productivity in steel manufacturing as a result of replacing old equipment with a modern, state-of-the-art, continuous casting process. Similarly, computer-driven assembly lines, robotics, better equipment to promote energy conservation, and efficiency in transportation score heavily in the productivity sweepstakes. But the fact is that overall figures on investment in equipment are heavily influenced by information processing outlays, which are less important for enhancing manufacturing productivity. Recent data therefore hide the truly important trends.

Computations by Dr. Charles Steindel of the Federal Reserve Bank of New York, an expert on investment and capital costs, tell an interesting and disturbing story. To be sure, as Chart 1 shows, the annual percentage change in the overall net stock of business equipment has risen by 4 to 5 percent in each of the past four decades, and the 1980-1989 average annual rate of 4.1 percent compares favorably with the rates in the earlier periods. But, those figures include all equipment--ranging from the business furniture and fixtures that add almost nothing to manufacturing productivity, to the office equipment that does add something but not as much as equipment used directly in the production process, to the truly productive equipment that is really the heart of the matter. And when overall equipment figures are broken down, the recent trend in productive investment is shocking.

Steindel's net capital stock figures show an average annual increase in industrial equipment (and for equipment less information processing) of 4 to 5 percent for the three decades ending in 1979, but the trend is downward, falling to the abysmally low level of about 1.5 percent for the decade of the 1980s.

This extremely low level of productive investment portends slower growth and reduced U.S. competitiveness. It is a direct and significant threat to the standard of living of the American people.

- <u>Equipment Investment Crucial To Growth</u>

Recent research confirmed what many of us knew intuitively--that the volume of investment in equipment is a critical factor in the pace of economic growth and development. New research by Harvard professor J. Bradford De Long concludes that, for

a broad cross-section of nations, every 1 percent of GDP that is invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent--a very substantial rate of return. De Long therefore also concludes that investment in equipment is perhaps the single most important factor in economic growth and development.

According to De Long, the link between machinery investment and economic growth is due to the embodiment of new technology in new equipment. He observes:

> New and improved technologies are greatly assisted by and in most cases require new capital goods and new types of capital goods. Without investing in the machinery that embodies the modern technologies of the industrial revolution, it is impossible to utilize them in production. [Harvard professor] Dale Jorgenson's estimates of production functions for individual industries find that productivity growth is strongly capital- and energy-using. Make capital goods (or energy) sufficiently expensive, and firms will not adopt more productive methods of operation.

Professor De Long's findings expand on earlier research he and Dr. Lawrence Summers, now the Treasury undersecretary-designate for international affairs, undertook on the importance of equipment investment to economic growth.

- U.S. Investment and Capital Costs

The user cost of capital is the pretax return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept often is called the "hurdle rate" because it measures the return an investment must yield before a firm would be willing to undertake the capital expenditure.

Although TRA substantially reduced corporate and individual income tax rates, the legislation's capital cost recovery provisions raised effective tax rates and capital costs for productive and pollution-control assets. This should be of concern to policymakers because the higher the cost of capital, the fewer the investment projects that will meet business hurdle rates.

According to estimates by an expert on capital costs, Dr. Joel Prakken of Laurence H. Meyer & Associates, the user cost for most types of productive equipment rose from 11 percent in the late 1970s to almost 19 percent in 1990, an increase of more than 70 percent (see Chart 2). The double-digit interest rates that emerged in the late 1970s were a major part of the increase in the first part of the period. The rise since 1981, however, has been almost entirely driven by tax increases on investment in equipment (i.e., the loss of the investment tax credit (ITC) and the lengthening of depreciable lives) and, to a lesser extent, the increase in tax rates on capital gains. Indeed, according to the Congressional Research Service (CRS), the user cost of capital for investment in equipment rose by 23 percent between 1981 and 1986, for tax policy reasons alone. Prakken's analysis reinforces the CRS findings, indicating that if the provisions of the Economic Recovery Tax Act of 1981 had stayed intact, rather than largely being repealed between 1982 and 1986, the user cost of capital for equipment in 1990 would have been substantially less than 19 percent.

The impact of TRA on U.S. industry can be illustrated by the following example relating to the present value of the capital cost recovery allowance when a corporation purchases new equipment. The present value of the capital cost recovery allowance for modern and competitive continuous casting equipment for steel production under the strongly pro-investment tax regime in effect from 1981 to 1985 was 98 percent, according to a study by Arthur Andersen & Co.

In contrast, under current law the present value of the capital cost recovery allowance for that same investment today is only 78.5 percent for a corporation paying the regular income tax. And if, as most major steel companies are, it is subject to the corporate alternative minimum tax (AMT), the present value is only 55.9 percent (see Table 3).

The Arthur Andersen study also shows that we lag behind many of our major competitors in equipment that is technologically innovative, crucial to U.S. economic strength, or helps prevent pollution. Examples are equipment used to make computer chips, robots for the manufacturing process, engine blocks and crankshafts for automobiles and trucks, equipment used in the continuous casting process for steel, and scrubbers. For firms in the AMT, the situation is even worse; these taxpayers rank last internationally or nearly last in terms of the amount of investment recovered.

- The Alternative Minimum Tax and Capital Costs

The corporate AMT has an especially pernicious effect on the cost of capital, as a study by University of Maryland Economics Professor Andrew Lyon reveals. TRA created a comprehensive AMT system separate from, but parallel to, the regular tax system. Under the AMT regime, taxable income is modified by an intricate series of "adjustments" to income, including depreciation. A high level of investment is a major reason firms become AMT taxpayers. Depreciation allowances for firms paying the alternative minimum tax generally are much less favorable than those for firms paying the regular corporate income tax (see Table 3). Today, an estimated 50 percent of large U.S. companies may pay the AMT rather than the regular income tax in 1991 and beyond. Yet, a high level of investment is exactly what is needed for increasing economic growth.

For example, an AMT firm investing in factory robot equipment encounters capital costs that are 17 percent higher than those faced by a firm paying the regular income tax (see Chart 3). Investment in pollution-control facilities fares even worse; capital costs for AMT firms are 22 percent higher than for firms subject to the regular income tax.

- Capital Gains and Capital Costs

Since capital gains are an important element of U.S. capital costs, high capital gains tax rates raise capital costs and thus impede productive investment. Stanford professor John Shoven and Boston Company economist Allen Sinai estimate that halving the capital gains tax rate would cut the user cost of capital upwards of 7 percent. Lower capital gains tax rates would encourage entrepreneurship and new business startups. This is because investors who furnish the necessary risk capital seek after-tax returns high enough to justify the considerable risk involved. The tax also hits heavily at phantom income-gains from inflation. This is wholly at odds with American ideas of fairness. Finally, U.S. capital gains taxes are much higher than those in most other industrialized countries; this provides an economic advantage to our competitors.

- The Role of Saving Incentives

ACCF research on the taxation of saving concludes the U.S. taxes personal saving--interest, capital gains, and dividends--much more harshly than our competitors. The Individual Retirement Account (IRA) is one approach to ameliorate the bias against saving.

Many tax policy experts, including the Treasury Department's Lawrence Summers, conclude that TRA's partial revocation of IRAs was an unfortunate response to the widespread belief that IRAs were ineffective in stimulating saving during the early and mid-1980s. These experts now believe that this conviction is not supported by the available evidence. While the official measured personal saving rate declined during the early and mid-1980s, this should not be taken as evidence that IRAs did not have a substantial impact on saving decisions. Many other factors affecting the saving rate have changed since 1981, so that any positive effect IRAs might have had has been masked. Higher stock prices, the

recession in 1982-1983, the desire of baby boomers to maintain the consumption levels enjoyed by their parents, reduced corporate pension contributions, increased consumer borrowing, and renewed consumer confidence all are possible explanations for the low saving rate. Without the enactment of IRAs, the saving rate might well have fallen even further.

The weight of the available evidence suggests that IRAs generated a significant amount of saving that would not otherwise have taken place. Under current law, if IRAs were reinstated the government would lose about twenty-five cents for each dollar of contribution, according to Dr. Summers. If more than one-fourth of the money contributed to IRAs represents new saving, IRAs will increase private saving by more than their revenue cost. This means that net national saving will still increase on balance because the induced increase in private saving will be greater than the increase in government dissaving resulting from the higher government deficits.

Tax Restructuring with a Broad-Based Consumption Tax

Over the long term, the ACCF advocates restructuring the U.S. tax system so as to reduce the multiple taxation of saving and investment inherent in the income tax, thus promoting productivity and higher living standards.

The time has come to take a close look at a broad-based U.S. consumption tax such as a VAT. All of our major competitors, including Japan, Canada, and Germany, employ a VAT in their fiscal arsenals. Our low saving rate and large trade deficit emphasize the need to move away from relying so extensively on the income tax, which is biased against saving and investment, and toward a system which is neutral with respect to the saving/consumption decision. ACCF-sponsored research shows that federal spending cuts would be the strongest pro-growth way to "pay for" tax restructuring. However, if additional revenues are needed, a broad-based consumption tax, such as a value added tax (VAT), which would yield upwards of $30 billion per point per year, could provide the wherewithal for deficit reduction and for the tax initiatives for U.S. growth and competitiveness. Revenue from a U.S. consumption tax could finance an investment tax credit, reform of the alternative minimum tax, more favorable tax treatment for environmental protection investment, the restoration of a capital gains tax differential, and more liberal IRAs. If spending were restrained, it also would reduce federal dissaving and lower real interest rates, thus affording a further reduction in capital costs.

The Administration's Economic Program

President Clinton's comprehensive tax and fiscal plan has played well in Peoria. It appears to enjoy a good chance of ultimate Congressional approval, albeit with emphasis on heavier and earlier spending cuts and with assorted, yet unforeseeable, changes in some of the tax provisions. How the program will be changed and how fast it will move through Congress are the questions most people are asking.

However, these are not the only important questions. Central to the restoration of rising living standards for the American middle class is how the program will be playing in Peoria and elsewhere retrospectively in 1995-96. Will its passage ensure the economy's emergence from the relative stagnation of the past two decades? And will the economy be on the rise from mid-1995 through November, 1996--the crucial period for the presidential sweepstakes?

If, as many experts believe, inadequate private capital formation has been a key factor in the economic sluggishness (not just the recession) of recent years, then the Clinton plan must on balance help step up the rate of capital formation. If, in fact, not simply jobs, but rewarding, high-paying jobs are to be created at a faster pace, the rate of business investment in plant and equipment must increase substantially. As noted earlier, Japan has been investing more than twice as much per worker as the United States.

Capital formation results from saving that is converted into investment. Thus, the abysmally low national saving rate--down from an average of about 7 percent in 1960-1981 to only 1 percent over the past two years--must be viewed as a major deterrent to private capital formation. Similarly, a slackening in business decisions to invest--perhaps because of weak markets, excessive taxation, or foreign competition--can also hold back capital formation.

Two major questions therefore emerge with respect to the impact of the Clinton plan on private capital formation. First, will it help raise the national saving rate? Second, will it increase the proclivity of decision-makers in business to step up productive investment rather than use available funds for other purposes?

- The Clinton Plan and National Saving

National saving is the composite of individual, business, and government saving. On paper, the Clinton plan would reduce the structural deficit from $258 billion in this fiscal year to $201 billion in 1997. Other things being equal, that deficit reduction would free up over $50 billion in additional saving for capital formation.

Other things are not equal, however. Clinton's individual tax increases are heavily tilted toward upper-income groups, which save much more heavily than those with lower incomes. Many such taxpayers will maintain their levels of consumption (or reduce them only slightly) and in effect pay the higher taxes by reducing saving. An improvement in savings incentives such as IRAs, 401ks, and laws governing pension contributions might have offset this impact somewhat, but no such proposals are included.

A drop in the individual saving rate is likely to be accompanied by a similar decline in business saving. This is because business' ability to save, through retained after-tax earnings, will be reduced by the increase in the corporate tax rate, the new energy tax, and the various provisions that on balance combine to raise the business tax burden.

Whether or not the Clinton plan, if enacted as proposed, would or would not increase national saving is difficult to say. What can be said is that it definitely will not contribute markedly to raising U.S. saving rates anywhere close to those in other industrial nations or, for that matter, to past levels achieved in the U.S.

- The Clinton Plan and Business Investment

Very little of the "investment" identified in the Clinton plan will be in the form of capital outlays in the private sector. The single strongly positive factor is the permanent extension of the R&D credit, a most worthwhile proposal. The AMT reform is a step in the right direction but, unfortunately, minimal in its impact in relieving the heavy taxation on investment. The two proposed investment tax credits will do little to enhance the growth of productive equipment that is so crucial to growth.

Of some $21 billion allocated to investment tax credits in the years 1994-1997, $12 billion accrue to businesses with $5 million or less in annual sales and the remainder to larger concerns. The ITC for small businesses is permanent. Unfortunately, small businesses invest only small amounts in the type of equipment that is so important to national productivity and competitiveness (see Chart 4). The 7-percent ITC for large companies is temporary and incremental. Incremental credits are unpopular in the business community, particularly among investment planners and tax practitioners, for a variety of reasons. A temporary ITC does little for productive long-term investment for two reasons. First, its impact on capital costs is small and fleeting. Second, the restricted time period for equipment to be put in place limits new equipment installations to very short-term projects and "off-the-shelf" purchases. The result is likely to be little more than a shifting of some business investment in equipment that would take place in 1995 and 1996 forward to 1993 and 1994.

A permanent ITC for large businesses would also help reduce the cost of capital for mandated pollution prevention and control equipment. ACCF research documents that U.S. tax treatment of pollution prevention and control outlays is less generous than most of our international competitors, including Canada, Germany, Japan, Mexico, and Brazil. Most of our competitors allow these expenditures to be expensed or written off in a period of three years or less.

Slow recovery of pollution control investment is a significant drag on U.S. industry for two reasons. First, the capital outlays are large. For example, in 1990 pollution control expenditures by business were about 7.1 percent of nonresidential fixed investment and an even higher 9.8 percent of producers' durable equipment. Second, prices for many manufactured products, natural resources, and agricultural goods, as well as some services, are set in world markets. To the extent that U.S. firms trying to compete internationally face capital cost recovery for pollution control equipment that is less favorable than their competitors, U.S. firms are at a competitive disadvantage. With the enactment of the Clean Air Act Amendments in 1990, the continuing debate over the reauthorization of RCRA, and other pollution prevention and control initiatives, it seems clear that business capital expenditures on pollution control will continue to absorb a significant share of capital spending during the 1990s. The ACCF urges the liberalization of the tax treatment of environmental protection investment.

We are pleased that President Clinton, his predecessor, and a majority of Congress recognize the penalty that our existing high capital gains taxes place on entrepreneurship and investment and economic growth. The economic case for a capital gains differential is that it reduces overall U.S. capital costs, prevents the taxation of inflationary gains, and encourages entrepreneurship. Against this standard, the President's capital gains proposal falls far short. Applicable only to new start-ups, confined to relatively small investments, and limited to certain types of businesses, little of the beneficial impact on capital formation that would flow from an across-the-board cut in capital gains taxes will occur.

Also very troublesome from an investment perspective is the proposed BTU tax on various forms of energy. Scholars such as Dale Jorgenson of Harvard, David Montgomery of Charles River Associates, and John Moroney of Texas A&M, have documented the importance of energy use to productivity growth. The implication of their research is that attempts to minimize the consumption of energy, whether through higher taxes on energy or through regulatory changes, will have adverse consequences for U.S. economic growth. For example, U.S. exports will bear the increased costs of energy taxes, while imports will not. Thus, a tax increase on this critical input to the production process is certain to impede job growth and competitiveness. While energy taxes may have political appeal as new revenue sources and as environmental measures, such proposals should be considered carefully before moving to the front of the nation's economic agenda. A broad-based consumption tax, such as a value added tax, is preferable to additional energy taxes.

The acid test of the Clinton plan on private capital formation depends to a considerable extent on the plan's ultimate impact on business capital costs. To be sure, deficit reduction will lead to lower interest rates and some capital cost reductions, but this will be offset at least in part by the negative impact of higher taxes on individual and business saving. The overall positive impact of the new proposed ITCs, AMT reform, and capital gains tax cut will be small. The negative economic impact of enacting higher individual and corporate income tax rates cannot be ignored. Enacting additional energy taxes, especially at this point in the recovery, is a risk not worth taking. On balance, the best guess today is that the ultimate impact of the Clinton plan on capital costs is too close to call.

Conclusion

Once again, we come to the old dictum: "The president proposes but Congress disposes." In all likelihood, Congress will give President Clinton a large part of what he has asked for.

But, if capital formation is to be stepped up, Congress should give serious consideration to amending the proposal in the following ways:

- **Ensure that the federal spending cuts are real and enforceable to increase national saving.**

- **Liberalize IRAs and improve other saving incentives to promote personal saving.**

- **Broaden the capital gains tax cut to bolster venture capital, boost the value of equity and real estate, and reduce business capital costs.**

- **Restore a truly effective investment tax credit to encourage business purchases of the equipment that is so essential to jobs, growth, and competitiveness.**

- **Expand the AMT reform by removing capital expenditures as a "tax preference" and make the ITC fully creditable against the AMT to reduce the cost of capital for investment.**

- **Enact a broad-based consumption tax to substitute for the proposed BTU tax and increases in individual and corporate tax rates and to finance pro-saving and investment tax reform.**

Table 1
Saving and Investment as a Percent of Gross Domestic Product, 1973-1990

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net Saving/1	4.4%	8.7%	19.0%	8.9%	10.8%	5.2%
Personal Saving/2	5.4%	7.1%	12.0%	7.1%	8.2%	2.9%
Gross Saving (net saving plus consumption of fixed capital)/3	17.0%	20.2%	32.6%	21.3%	23.0%	16.8%
INVESTMENT						
Gross Non-Residential Fixed Capital Formation	13.1%	15.5%	23.9%	14.9%	14.7%	14.4%
Gross Fixed Capital Formation	17.8%	21.9%	30.1%	21.1%	20.6%	18.1%

1/ The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.

2/ Personal saving is comprised of household saving and private unincorporated enterprise.

3/ The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.

Source: Derived from National Accounts, Vol. II, 1973-1985 and 1977-1989, Organization for Economic Co-Operation and Development (OECD), 1987 and 1991 eds. Prepared by The American Council for Capital Formation Center for Policy Research, February 1993.

Table 2
Growth in Investment During the Early
Stage of Recent Economic Recoveries
(Constant 1987 Dollars)

	Annualized Growth Rates		
Early Recovery Phase of Business Cycle a/	Nonresidential Fixed Investment	Producers' Durable Equipment	Producers' Durable Equipment
1970(4)-1972(2)	4.6%	7.5%	8.5%
1975(1)-1976(3)	2.1%	3.5%	2.8%
1980(3)-1982(1)	3.9%	0.6%	-1.7%
1982(4)-1984(2)	10.9%	16.1%	13.5%
1991(2)-1993(4)	3.7%	8.8%	2.1%

Source: U.S. Department of Commerce. Prepared by the American Council for Capital Formation Center for Policy Research, March 1993.

a/ The business cycle turning points are determined by the National Bureau of Economic Research.

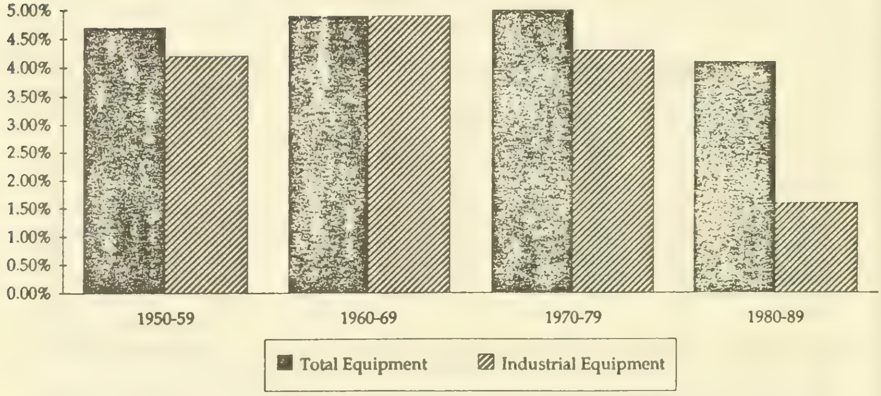
Table 3
International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution-Control Equipment
(As a Percent of Cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	98.0	98.0	98.0	98.0	98.0	98.0	98 0	98.0	86 8
MACRS	83.4	83.4	78.5	78.5	78.5	78.5	83 4	78.5	50 8
AMT-ACE	79.3	76.4	66 2	61.8	55.9	57.9	67.4	59 8	38.6
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79 4
Canada	73.4	72.2	70.3	70.1	70.5	69.9	82.8	82.8	82.8
Germany	80.7	80.1	79.8	81 1	79.3	81.1	67.6	65.5	64 6
Japan	78.8	77.5	73.5	74 4	70.9	74.1	75.2	74.2	72.9
Korea (w/ 3% ITC)	86.2	81.3	79.6	76.9	74.4	76.5	94.2	93.1	91 8
Singapore	90.1	90.1	90.1	90.1	90.1	90.1	90 0	90 0	90 0
Taiwan	80.6	73.7	75.1	58.4	57.7	57.9	144 1	144 1	144 1

Source. Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation. How Bad is Bad." *Economic Effects of the Corporate Alternative Minimum Tax.* Published by the American Council for Capital Formation Center for Policy Research (Washington, D C . September 1991).

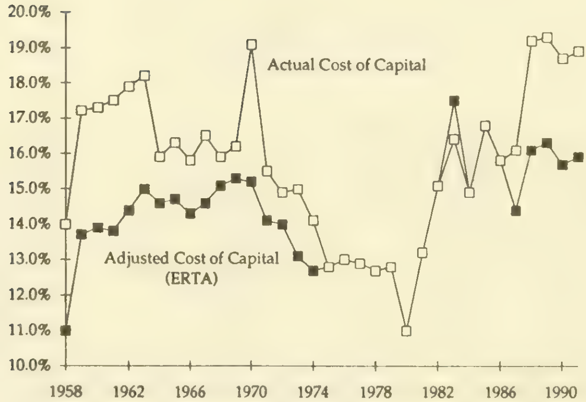
Notes 1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985 or the Economic Recovery Tax Act of 1981 as modified by the TEFRA (1982) and DRA (1984), the 10% ITC is treated as an equivalent deduction. MACRS refers to the capital cost recovery provisions of the Tax Reform Act of 1986 The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent. Current law alternative minimum tax (AMT-ACE) refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted earnings rule. The calculations assume the firm stays on the minimum tax.

Chart 1
Growth in the Net Capital Stock by Type



Source: Charles Steindel, "Recent Trends in Capital Formation." *U.S. Investment Trends: Impact on Productivity, Competitiveness, and Gro* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, March 1991). Table modified by the ACCF Center for Policy Research.

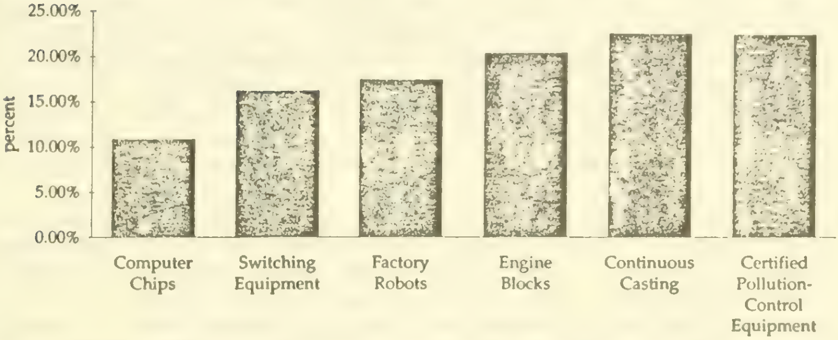
Chart 2
Cost of Capital for Equipment



Source: Joel Prakken, "Commentary," *U.S. Investment Trends: Impact on Productivity, Competitiveness, and Growth* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, April 1991).

Note: The cost of capital is defined as the user cost of capital, it includes economic depreciation. Calculations exclude office, computing and accounting equipment.

Chart 3
Increased Cost of Capital for Equipment Incurred by AMT Firms Compared to Firms Paying the Regular Income Tax1/

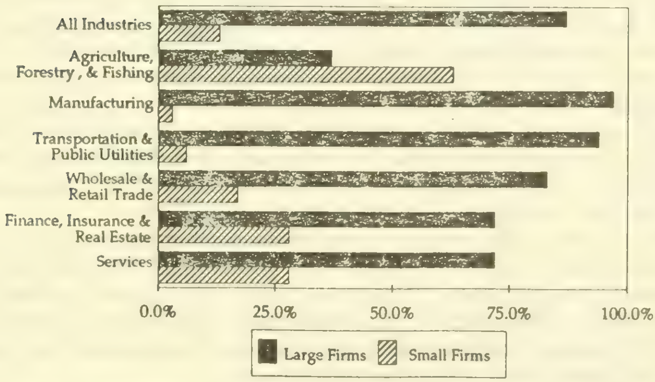


Source:: Andrew B. Lyon, "An Analysis of the Alternative Minimum Tax: Equity, Efficiency and Incentive Effects." *Economic Effects of the Corporate Alternative Minimum Tax* (American Council for Capital Formation Center for Policy Research, Washington, D.C. September 1991).

Notes: The analysis assumes that firms are alternative minimum tax (AMT) payers for ten years.

1/Equipment used to make selected manufactured products and pollution-control equipment.

Chart 4
Investment in Plant and Equipment by Size of Business in 1989
(Percent of Total)



Note: Large firms have annual sales in excess of $5 million per year; small firms have less than $5 million in annual sales.

Source: Data from Department of the Treasury, Internal Revenue Service, "Statistics of Income, Corporation Income Tax Returns" (1988 and 1989 eds.). Chart prepared by the American Council for Capital Formation Center for Policy Research, February 1993.

Mr. KOPETSKI. Welcome, Mr. Donohue.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN TRUCKING ASSOCIATIONS

Mr. DONOHUE. Thank you, Mr. Chairman. I am president and chief executive officer of the American Trucking Associations. ATA represents the approximately 200,000 companies employing 7.8 million people who work in the trucking industry. To put that in perspective, the trucking industry is about three times larger than all of the other transportation modes combined. In fact, one in twelve civilian private sector jobs in this country is in the trucking industry.

Let me begin by commending President Clinton for recognizing and responding to the public's concern about the health of our economy. His program is good-spirited and well-intentioned. Further, I would extend my thanks to the Congress for recognizing that more spending cuts were needed and then for finding them. We should all applaud the administration for its efforts to loosen bank credit, particularly for small companies. An economic recovery requires capital investment.

In our industry, which includes as I said more than 200,000 small companies, many of whom have fewer than six trucks, this program is absolutely essential. There are, however, a number of unanswered questions about the necessity and the structure of a stimulus package. In addition, there is concern about the timing of the whole economic package. My personal concern is that families and businesses in all economic brackets are deferring spending decisions to see what the government is going to do next, and we are seeing that in the purchases in our industry right now.

In the interest of staying within my time limit, let me focus on four of the foremost important things to the trucking industry. We need a strong growing economy; the stronger it is, the more freight we carry. We all agree to the need for a deficit controlled within reason, and it should be controlled as much as possible through reduced spending. Taxes, which we are going to have some of, should be a last resort, but if they are needed, they should be balanced, fair, and reasonably allocated to those that have to pay them.

Whatever we decide, we have got to decide soon because people simply will not make spending decisions until the Government clarifies the ground rules. As to taxes, Mr. Chairman, let me first applaud the decision by the administration not to pursue a fuel tax with deficit reduction. I hope it won't reappear.

But the trucking industry certainly isn't celebrating the proposed Btu tax because it is, in effect, a camouflaged fuel tax. It is unfairly allocated. As proposed, it is more than two times higher on petroleum than on other energy sources and leads one to wonder if some specific interest might have had more influence on the inception of that tax than those that use petroleum.

I would like to remind the committee that 54 percent of the American families earn less than $30,000, and that includes small companies, and those people are the ones that are going to pay the excise taxes. The administration's proposed 8 cents a gallon fuel tax comes on top of 5 to 7 cents we will have to spend on January

1 for clean diesel fuel and the 5 cents we put in in 1990. You add that up and that gets to be about 20 cents.

Now, let me quickly hit a few other points important to the industry. Truckers, those that drive trucks, often spend 5 to 6 and sometimes more days a week on the road if they have to stay over to rest. They don't eat at fancy restaurants and they don't entertain high-powered clients, but this drop in the meal deduction that is discussed will affect both owner/operators and driver employees. It is really quite unfair. One would have to wonder that as Government employees travel on official business, if they will be allowed to eat only every other day.

The investment tax credit has taken our attention. At first blush it sounds pretty good. The administration has described the credit as a 7-percent credit. In fact, it would be far less than that for most businesses. It would be worth only about 1 percent on the purchase price of a new tractor and even less for many companies. The proposal is much too uneven to be fair or genuinely stimulative. For instance, the leasing companies on which many truck companies depend for their equipment cannot pass it on to their customers.

Well, finally let me say a word about the corporate tax rates. The trucking industry has a very, very narrow profit margin, about 2 percent, and as a result, difficulty in attracting investment capital. The taxes go up, so does the difficulty. With all of our trucking companies trying to serve all of the rest of industry, and doing so so efficiently as to support our consumption in the United States and our exports around the world, we don't need unnecessary taxes.

Let me conclude, sir, by saying we are going—if we are going to have a tax, it must be fair, balanced, and equitable. New taxes cannot single out a certain group of individuals or a specific industry or a particular geographic area. If we are going to raise taxes to reduce the deficit, they must be broad based and fair. This industry wants to work with you and the Congress to get it done, but we want—and we want to be a part of the solution, but it is going to be very hard to get our support for an economic package as long as the energy tax is so unbalanced and the meal deductions hit on the little guy, the person that is trying to go around this country every day and deliver the Nation's goods.

We look forward to working with you and we hope we can resolve some of these issues. Thank you very much, Mr. Chairman.

Mr. KOPETSKI. Thank you very much, Mr. Donohue.

[The prepared statement follows:]

Before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

March 16, 1993
Washington, DC

Statement of the

AMERICAN TRUCKING ASSOCIATIONS, INC.

on

TAX PROPOSALS FOR STIMULUS AND DEFICIT REDUCTION

INTRODUCTION AND SUMMARY

My name is Thomas J. Donohue. I am president and chief executive officer of the American Trucking Associations (ATA), the national trade association of the trucking industry. I appreciate the opportunity to comment on tax proposals for economic stimulus and deficit reduction on behalf of the more than 30,000 companies that belong to ATA or its 51 state affiliates and 10 specialized national affiliates.

The trucking industry employs 7.8 million Americans, accounts for approximately 5% of gross domestic product, and plays a central role in the competitiveness of U.S. industry. Clearly, the industry's health is closely tied to that of the economy as a whole, and we are vitally interested in proposals to improve economic performance in both the short and the long run.

The President has proposed an ambitious package of spending and tax changes. Overall, the spending changes are in the right direction, and the House and Senate Budget Committees have moved to improve the ratio of spending cuts to tax increases. In addition, the President has recently proposed improving the availability of bank credit, a vital form of stimulus for the small businesses that make up the vast majority of the nation's 200,000-plus trucking companies.

As for the President's tax proposals, the trucking industry is prepared to make its share of sacrifices to achieve lasting economic improvement. But we do not believe it is fair to require trucking to make extra sacrifices for goals that are intended to benefit all Americans. Specifically:

- ATA does not oppose a truly broad-based, level energy tax, even though that does place a burden on energy-intensive industries. But a tax that falls more than twice as heavily on transportation as on other users of other energy sources is neither fair nor balanced and must be adjusted.

- Several other business tax increases will hurt the trucking industry. Cutting back the business meal deduction to 50% of actual cost is an injustice to thousands of long-haul truck drivers whose on-the-road meals are a modest and fully justified business expense. Corporate and individual rate increases are an unfortunate step back from the 1986 Tax Reform Act, which the trucking industry supported. And longer writeoffs for business structures will penalize expanding trucking companies.

- o Neither a temporary, incremental investment credit, nor a permanent credit that is available only to certain small businesses, will deliver effective stimulus. Both credits will cost more than they are worth in complexity and offsetting revenue increases. They should be changed to be fair and equally available or else scrapped.

- o In contrast, the proposed alternative minimum tax depreciation relief is an evenhanded, low-cost simplification that should be adopted promptly.

- o We applaud the recent recommendation to move the 2.5-cent general fund fuel tax into the Highway Trust Fund. The full amount should go into the highway account and be spent in timely fashion.

BROAD-BASED ENERGY TAX

Our number one concern is the proposed BTU tax. Although ATA would prefer that energy-intensive industries not be discriminated against, we would find a truly broad and level energy tax acceptable. However, a tax that falls more than twice as hard on petroleum users as on other energy users constitutes a camouflaged gas tax. It is not fair or balanced and must be adjusted.

The Administration has proposed to tax natural gas, coal and electricity from nuclear and hydro sources at a rate of 25.7 cents per million BTUs (British thermal units), a measure of heat content. Petroleum would be taxed at 59.9 cents per million BTUs, two and a third times as high a rate as for other fuels. These taxes would begin on July 1, 1994 at one-third of the above rates, rising to two-thirds on July 1, 1995, and the full rate on July 1, 1996. Thereafter, the rates would be adjusted for general inflation as measured by the change in the gross domestic product (GDP) deflator.

The 1996 rates would amount to 7.5 cents per gallon for gasoline and 8.3 cents per gallon for diesel fuel, based on the heat content of each fuel. These rates would be very costly for the trucking industry, which uses roughly 12 billion gallons of gasoline and 24 billion gallons of diesel fuel per year.

BTU tax unfairly burdens trucking

At 1996 tax rates, commercial truck owners would have to pay roughly $2.9 billion in added fuel costs in fiscal 1997, or 10% of the gross revenue projected from the tax. This burden is totally unfair, given that trucking accounts for less than 5% of GDP. Put another way, at 1992 profit levels, the tax would equal roughly 50% of the industry's profits.

Truck owners and other highway users have already been paying more than their share for deficit reduction. Since the 1990 budget agreement, 2-1/2 cents per gallon of fuel tax revenue has been diverted into the general fund instead of the Highway Trust Fund. That provision adds $900 million per year to the fuel bills of commercial truck owners.

There is no justification for placing such an enormous added tax burden on the freight transportation industry, when that industry plays a vital part in enhancing U.S. international competitiveness and the tax is intended to benefit the entire economy.

Administration officials have mentioned but not specified "externalities" or environmental costs associated with petroleum. But there are already a variety of both explicit and hidden environmental taxes on petroleum and various products. Explicit federal taxes include the Superfund, Leaking Underground Storage Tank, and Oil Spill Liability Trust Fund taxes. Many states have similar taxes, some at even higher rates than the federal taxes. In addition, gasoline users in much of the nation must now pay 5-10 cents more per gallon in winter months for oxygenated fuel. And by next October, highway diesel fuel will cost an estimated 4-7 cents per gallon more to cover the cost of reducing the fuel's sulfur content in accordance with Clean Air Act rules.

Adding the Administration's camouflaged 8-cent fuel tax to the clean diesel "tax" means that truck operators will be paying as much as 15 cents a gallon for purposes that do nothing to build highways or transit, on top of 20 cents a gallon of federal highway fuel tax and nearly 20 cents of state fuel taxes. This is an extraordinary set of tax burdens to impose on an industry whose profit margin hovers around 2%.

In short, the case has not been made for singling out transportation for a higher rate of BTU tax than other energy users.

RECOMMENDATION: If a broad-based energy tax is adopted, lower the rate on petroleum to the same level as other fuels.

Indexation of the BTU tax

The Administration has proposed indexing the BTU tax after 1996. Indexing has never before been used to create unlegislated tax increases. (Income tax indexing, in contrast, is used to assure that inflation alone does not increase individual tax burdens.)

We think it would be unwise for Congress to abandon its oversight over excise tax rates in this case, for several reasons. First, increasing rates will add to discrimination against energy users, shifting an ever larger share of the deficit reduction burden onto these taxpayers.

Second, the wide swings in price indexes add uncertainty about future energy tax rates that will make it difficult for truck buyers and other energy-intensive businesses to plan investments efficiently. The proposed indexing mechanism, the GDP deflator, has varied from a 10% change in 1981 to a 2.6% change in 1986, and other indexes have varied even more.

Third, the BTU tax will induce enough conservation to depress Highway Trust Fund receipts, once again undermining the solvency of the highway spending program. The Administration's proposed level of petroleum tax would cost the Highway Trust Fund roughly $300 million in fiscal 1997 by driving up fuel prices and thus curbing demand. Indexing the BTU tax could lower trust fund receipts even more in future years.

OTHER BUSINESS TAX INCREASES

Business meal deduction

The Administration has proposed to limit the deduction for business meals and entertainment to 50% of cost rather than the current 80%, effective January 1, 1994.

Medium- and long-haul trucking companies or their drivers (whether employees or independent contractors) incur a large amount of business meal expenses. Many drivers eat all meals away from home 200 or more days per year. They are either reimbursed for those meals at the federal per diem rates of $26 to $38 per day, or make use of IRS meal allowance rules that permit them to claim these legitimate business expenses. Denying 50% of that modest, unavoidable expense is not fair tax policy.

RECOMMENDATION: Do not cut back the deduction for meals, at least for meals that do not exceed the top federal per diem rate.

Individual and corporate rates

The trucking industry was an early and vigorous supporter of the 1986 Tax Reform Act. Even though many carriers wound up with higher tax bills, the industry felt that low top rates for individuals and corporations would be good for the economy and would reduce tax-driven decision-making.

Now the Administration has proposed to increase the top individual rate to nearly 40% and the top corporate rate to 36%, for companies making more than $10 million. But the owners of these large companies are more likely to be pensioners and middle-class investors than millionaire "fat cats." Unlike individual tax rates, corporate tax brackets do not correspond to the income or wealth of the individuals who own the companies. A lower maximum corporate rate, applied to all corporate income, would be fairer than a surtax on a minority of giant companies.

RECOMMENDATION: Minimize the increase in individual and corporate rates.

Longer writeoffs for structures

The Administration has proposed to give limited relief from passive loss rules to real estate professionals. The revenue loss from this change is to be made up by stretching out the depreciation period for structures, including trucking terminals and warehouses, to 36 years, from 31.5 years currently.

Few trucking companies or other businesses would benefit from the passive loss relief. Yet all businesses that build or buy nonresidential structures would recover their depreciation costs more slowly under these changes.

RECOMMENDATION: Do not penalize owners of nonresidential structures by lengthening depreciation periods.

INVESTMENT TAX CREDIT

The Administration has proposed a two-tier ITC. Businesses with gross receipts under $5 million would be eligible for a

permanent credit on all equipment; larger businesses would be eligible for a temporary credit (through 1994) on purchases that exceed a certain percentage of historical investment. Credit percentages would vary according to the depreciation recovery period assigned to each asset type. A large number of other rules would further limit the amount of credit on each investment.

Our judgment is that neither the permanent small-business ITC nor the temporary incremental ITC would provide any short- or long-term investment stimulus in the trucking industry.

Many trucking companies invest primarily in tractors (the power units that pull trailers), which have a three-year recovery period. Other investment dollars go heavily for trucks (power units with attached cargo space) and trailers, both of which are in the five-year writeoff class. Even the maximum credit rates for these asset classes, as shown in the table below, are too low to provide effective stimulus to investment. Further restrictions on companies subject to recapture or basis adjustment, minimum tax, net operating loss, aggregation, startup, passive-loss, at-risk and other rules water down the benefit still more.

MAXIMUM ITC RATE AND TAX SAVINGS FOR TYPICAL TRUCKING ASSETS

	Small carriers		Large carriers	
	'93-94	Post-'94	'93-94	Post-'94
ITC rate on:				
Tractor	2.33%	1.67%	1.17%	0
Truck or trailer	4.67%	3.33%	2.33%	0
Maximum tax savings on:				
$50,000 tractor	$ 770	$ 550	$ 385	0
$50,000 truck or trailer	1540	1100	770	0

Note: Maximum tax savings equal percentage shown times $50,000, less 34% basis adjustment or recapture. If Administration's proposed 36% corporate rate is adopted, many large carriers would save even less.

Truck leasing companies are particularly concerned about the incremental credit. Unless appropriate anti-abuse rules are written, their customers would have an incentive to switch from leasing to purchasing equipment so as to get an ITC. The Treasury has acknowledged the need to avoid this tax-driven result, but crafting effective rules may not be easy.

The more restrictions that are imposed to limit abuses or revenue losses, the more money and effort businesses must expend in trying to understand and comply with the rules instead of actually investing. On the other hand, with or without detailed rules, the tax treatment of similarly situated companies is likely to vary.

The case has not been made that an ITC provides very effective short-run stimulus, or that it is a fair way to help business in the long run. And, even though most trucking companies have less than $5 million in gross receipts, they benefit more from tax changes that help the economy as a whole than from changes targeted only at certain small businesses. Furthermore, the $30 billion cost of the ITC proposals over fiscal 1994-98 requires unacceptable increases in other taxes as a result.

RECOMMENDATION: Either make the ITC fairer and more even or scrap both forms of ITC. Use the savings to eliminate the petroleum differential in the BTU tax, the cutback in the business meal deduction or part of the individual and corporate tax rate increases. Any of these changes would be fairer and less complex.

AMT DEPRECIATION RELIEF

The Administration and Chairman Rostenkowski have separately proposed to simplify and slightly liberalize the depreciation calculation for alternative minimum tax (AMT) purposes. We applaud this long-needed step, which will help all businesses in a nondiscriminatory fashion at minimal revenue cost. In fact, the revenue loss should be even less than the Treasury and Joint Committee on Taxation staffs have estimated, given the savings on compliance that both taxpayers and the Internal Revenue Service should realize from eliminating this arduous calculation.

RECOMMENDATION: Adopt AMT depreciation simplification and relief, with the earliest possible effective date.

GENERAL-FUND FUEL TAX

The Administration recently modified its package to recommend that the 2-1/2-cent general-fund fuel tax (now scheduled to expire in 1995) be continued permanently but be added to the Highway Trust Fund after its current termination date. We strongly support this recommendation, provided that the full 2-1/2 cents goes into the highway account and is spent on a timely basis for highway purposes in accordance with the terms Congress approved in the Intermodal Surface Transportation Efficiency Act of 1991. Using the funds for nonhighway purposes, or impounding them to make the deficit look smaller, would again be an unjustified added burden on highway users.

The full amount is needed in order to assure that there is enough money in the highway account after 1995 to keep spending at appropriate levels. Given the long lead time on highway planning and construction, it is essential that the funding be assured today. In fact, fairness and trust fund solvency would be improved still more by shifting the 2-1/2 cents back to the Highway Trust Fund effective immediately, instead of waiting until late 1995.

RECOMMENDATION: If the 2.5-cent general fund fuel tax is extended, the proceeds should go to the highway account of the Highway Trust Fund and be spent on a timely basis for appropriate highway purposes.

MACROECONOMIC EFFECTS AND CONCLUSION

The Administration has proposed a complex set of tax and spending cuts and increases, which are intended to achieve a combination of short-term stimulus and higher long-term growth through better-targeted government spending and lower deficits.

These proposals will have mixed effects on trucking. Probably the most important effects are the macroeconomic ones: the impact on growth, employment and inflation. On that score, we would make two observations. First, the trucking industry in general does not feel the need for additional stimulus. Tonnage, revenue and employment has been picking up since late 1991 or early 1992. There are probably more carriers looking for qualified truck drivers and mechanics than laying them off. Moreover, there is a lot of skepticism as to whether spending and tax "stimulus" is likely to be needed, effective or desirable, given the steadily improving economy and the prospect of paying for deficit expansion now through higher taxes later. Many trucking executives would prefer to skip both the stimulus and the tax increases and get immediately to deficit reduction through spending cuts.

Having said that, however, the trucking industry is certainly willing to make its share of sacrifices, if that will contribute to long-run, noninflationary growth. But we believe any sacrifices must be fairly shared. We do not believe we should be singled out to pay more than our share for national goals--be they short-term stimulus, long-term investment or deficit reduction--that are intended to benefit everyone.

In addition, there are several tax proposals that have particular implications for trucking. These include the BTU tax, the extension of the general fund fuel tax, and the cutback in the business meal deduction. Each of these should be implemented in a nondiscriminatory fashion or else dropped.

Mr. KOPETSKI. Mr. Motley. Welcome.

STATEMENT OF JOHN J. MOTLEY III, VICE PRESIDENT FOR FEDERAL GOVERNMENTAL RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you, Mr. Chairman. I would like to thank you and the committee for the opportunity to share the views of NFIB's more than 600,000 small independent business members across the United States on the impact of President Clinton's proposed economic program on smaller firms.

I would like to summarize my written statement in three points. First, the size of the deficit is extremely important to small business owners for many reasons. On that point, I would like to commend the President for his focus on the deficit. It is something that is extremely refreshing to the small business community in the country. In 1991, in a series of surveys, and we survey our members often, 87 percent of them said that they would prefer the Government focus on deficit reduction than on anything else at that time, including domestic and international problems that we had. And 72 percent of them in a different survey favored reduction in the deficit over cutting their own taxes. Only 27 percent of them said that they would prefer to have their taxes cut, and allow the deficit to grow.

We believe that Congress and the President have a unique opportunity with what has happened in the country recently and they should seize this opportunity to take an even bigger bite of the deficit.

Second, small business owners believe that the deficit is primarily a problem of too much spending, not of too little taxes. Therefore we at NFIB believe that the mix of taxes to spending in this package is too high. NFIB economists, Tom Gray, who used to be the chief economist of the U.S. Small Business Administration, and Bill Dunkleberg, the dean of the business school at Temple University, are fearful that the amount of taxes in this package, particularly in the early years, will blunt the recovery and that they will provide very little long-term stimulus.

The reason is that the stimulus and tax incentives in the package for the business community are far outweighed in our opinion by the amount of taxes that the business community is going to be asked to shoulder in future years. Our suggestion for improving the package is to strip out the approximately $240 billion in stimulus—both in spending and in taxes, and to eliminate $240 billion in tax increases that are in the package now.

Third, Mr. Chairman, the plan has been presented in language that praises small business in the United States as a unique job-generating engine, and that from all the statistics that we have seen, is true. But if the object is to get small business owners in this country to go out and create jobs, we believe that the package is poorly targeted and will not get the intended results.

Let me give you some examples. First of all, the ITC investment tax credit aimed at smaller firms, it is good that it is permanent, it is very good that it is nonincremental, two things that we recommended in an ITC, but we don't have an awful lot of the details

but we understand it is very likely that computers are not going to be included.

If you are talking about small businesses, that is one of their primary investments as they move forward. The first thing a service firm generally does when it opens up is purchase a computer system.

Second, the capital gains tax reduction. It is good because it recognizes the need for long-term risk capital in smaller businesses, but it is poorly targeted because it only covers C corporations and 80 percent of the businesses that do business in the United States are not C corporations. They are unincorporated and most new business start-ups are not C corporations. They are either proprietorships, partnerships, or as we encouraged in the 1986 Tax Act, subchapter S corporations. A far better and more effective stimulus from our standpoint, if you are looking for one, would be to take the expensing provisions of the code and increase them to $25,000. That would stimulate small businesses across the board.

But if the real focus is jobs, then why in our opinion should you hit the job creators the hardest with the tax increases in this proposal? The biggest tax increases that we see are for unincorporated growing businesses, especially those in the retail area. They are hit by a multitude of taxes. The rate increases from 31 to 36 percent. The lifting of the HI cap and a 2.9 percent increase in the taxes there, the alternative minimum tax increases, Dr. Feldstein said before that his calculation is that you would have roughly a 25 percent marginal tax increase. You add on this the limit on business meal deductions, the new Btu tax and you put all of this on top of what happened in 1990 when they were roughly the only group of people who received significant tax increases in that package, and I think you have a situation which is not very stimulative within the job-producing sector of the small business economy.

In conclusion, Mr. Chairman, it is very difficult for us at NFIB to see where this proposal expects to get the private sector job creation when it hits America's job creators, small, independent, unincorporated businesses the hardest.

Thank you.

Mr. KOPETSKI. Thank, Mr. Motley.

[The prepared statement follows:]

TESTIMONY OF JOHN J. MOTLEY III
National Federation of Independent Business

Mr Chairman. I want to thank you for this opportunity to appear before your Committee. I appreciate this chance to present our views on how President Clinton's "Vision of Change for America" will impact this nation's small business owners.

NFIB is currently celebrating its 50th year of bringing the views of small business owners across the country to Washington, D.C. It is the nation's largest small business advocacy organization, representing more than 600,000 small and independent business owners nationwide.

INTRODUCTION

President Clinton has asked the American people to look at his proposal as a package and not to pick it apart and criticize its individual elements. Since this is NFIB's first opportunity to comment in detail on the Administration's "Vision of Change," I want to honor the President's request and comment on his proposal as a package. I realize that some of the changes I will suggest fall outside of this Committee's jurisdiction, but to understand the reaction of the small business community to the President's proposal, it is important to focus on more than just the suggested changes in the tax code.

THE IMPORTANCE OF DEFICIT REDUCTION TO SMALL BUSINESS

NFIB's positions are determined by polling our membership. NFIB has no policy boards or committees that set its policy. Every NFIB member has the same opportunity as every other NFIB member to determine the positions our organization takes.

Our members have repeatedly told us that deficit reduction is a top priority for them. Two 1991 NFIB polls indicate the importance of reducing the deficit to small business owners. In the first poll, 87% of NFIB members said that Congress should primarily focus its attention on deficit reduction. Only 8% of NFIB's membership, however, believes that the deficit should be reduced through tax increases. The second poll is more telling of the level of concern small business owners feel about the deficit. In this poll, small business owners were asked if Congress should enact tax breaks for small business or work on reducing the deficit. Seventy-two percent thought Congress should work on reducing the deficit, and only 27% voted for tax breaks.

Small business owners see the deficit as a double threat. First, they consider the deficit to be a serious brake on economic growth. Presently, Germany and Japan are willing to finance our debt by buying U.S. Treasury bonds. As they face increasing economic problems in their own countries and geographic regions, more and more of the U.S. debt will be financed by Americans who will lend money to the federal government instead of investing in businesses. This will make it increasingly difficult for business owners to find the investment capital they need to succeed. According to Martin Feldstein, the deficit will consume about half of the net savings generated by households and businesses.

The second threat is one that is not peculiar to business owners. This is the threat the deficit poses to future generations of Americans. Small business owners, like the vast majority of Americans, are concerned about the current trend of government to spend money now and have taxpayers pick up the tab in the future.

Small business owners believe that the deficit is a result of too much spending, not too little taxation. This belief is verified by the numbers. From 1977 to the present, the government received a relatively steady 19% of GNP in revenues. During the same period, government spending increased from 21% to 24%. Unfortunately, the President's plan does very little to stem the increase in federal spending. In fact, the plan will actually result in a net increase in non-defense discretionary spending.

Three times in the last decade, Congress and the President told small business owners that it was impossible to balance the budget by just cutting spending. Three times Congress and the President put together packages of tax increases and spending cuts. Three times taxes went up and spending went up. The last of those three packages, the Budget Enforcement Act of 1990, was a complete failure. This budget agreement was supposed to raise $165 billion in new taxes and cut $325 billion in spending between 1991-95. In fact, it is expected that the federal government will lose $529 in revenue and spend $180 more during this period. Although the recession had a large impact on these numbers, some economists believe the 1990 tax increases triggered the recession.

CREATING NEW JOBS

The top priority of Congress should be to encourage strong economic growth to create new jobs. If job creation is the problem, small business is the answer. According to the Small Business Administration, small businesses created 4.1 million new jobs from 1988 to

1990. During this same period, businesses employing more than 500 employees had a net loss of 500,000 jobs. Creating an environment in which small business owners are encouraged to grow and expand their businesses will result in the maximum amount of job creation.

President Clinton's economic plan starts with the faulty premise that the federal government can actually create new, long-term jobs. The federal government cannot create wealth; it can only redistribute it. NFIB members are concerned that the tax increases used to pay for these new jobs will destroy more jobs in the private sector than they will create overall. In fact, there is very little evidence that government-generated jobs programs are ever effective in providing benefits after the government finishes handing out paychecks.

According to studies performed by the Urban Institute, attempts by the federal government to bring additional young workers into the labor force have been a failure. The federal government spent $35 billion on employment programs through the Comprehensive Employment and Training Act (CETA). The Urban Institute found that this federal spending resulted in earnings losses for young men of all races and had no impact on the future earnings of young women who participated. Last May, a six-year study of the Job Training Partnership Act (JTPA) was completed by the Department of Labor. This study found that JTPA participants earned less than a control group of their peers who did not participate in the program. The federal government already spends $16.3 billion a year on 125 different employment and training programs. These programs are run by 14 different agencies and departments. Although increasing funding for jobs sounds politically attractive, these programs are very costly, rarely produce any positive results and sometimes cause more harm than good.

THE NEED FOR ECONOMIC STIMULUS

Many NFIB members are scratching their heads wondering why we need an urgent surge of federal funding to stimulate the economy. From their vantage point, the economy appears to be recovering quite well without any help from Washington, D.C. The following economic indicators demonstrate the economy's health and the lack of any need to stimulate it.

* The economy appears to be rebounding from the recent recession with growth of 3.4% in the 3rd quarter of 1992 and 4.8% in the fourth quarter, the fastest growth in 5 years.

* According to recent NFIB surveys, many NFIB members plan to increase investment in their businesses and expand inventory in the next few months.

* The nation's employers overall created 365,000 jobs in February, the biggest increase in employment in the last four years.

* The unemployment rate fell from a recession high of 7.7% to 7.0% in February, the lowest it has been since 1991.

NFIB members would prefer that the billions of dollars targeted to "job creation" be targeted toward reducing the deficit or offsetting the proposed tax increases. Engaging in one last binge of federal spending is the wrong way to start down the declared path of fiscal asceticism.

TAX PROVISIONS THAT WILL HELP SMALL BUSINESSES CREATE JOBS

President Clinton's package does contain two significant tax reductions for small business owners, the investment tax credit and a capital gains tax reduction.

Investment Tax Credit

The investment tax credit will encourage small business owners to increase their purchases of equipment and boost the productivity of their businesses. The investment tax credit contained in the President's proposal is designed well for small business use. The credit is permanent and not incremental. Temporary, incremental credits are difficult for small business owners to use. As long as this credit applies to the broad range of equipment small business owners purchase, it will be very useful in encouraging increased small business investment.

NFIB is concerned, however, that the investment tax credit is not the best incentive to increase equipment purchases, and that the incentive will favor equipment over labor. Many small businesses would prefer to see an increase in section 179 expensing instead of an investment tax credit. Expensing is simpler than an investment tax credit, and it produces the same results.

If the purpose of President Clinton's proposal is to create jobs, then the Congress may want to consider replacing the ITC with a jobs tax credit. Small businesses tend to be labor intensive, and in the vast majority of cases their labor costs exceed their capital costs. A tax credit against FICA would lower labor costs and encourage small business owners to hire additional workers. Replacing the ITC with a tax credit against the employer's share of FICA would encourage small business owners to hire more workers instead of encouraging them to buy more machines. In the late 1970's, a jobs tax credit was championed by a former member of this Committee, Majority Leader Dick Gephardt, and it could produce needed job creation.

Capital Gains Tax Reduction

The reduction in the capital gains tax will encourage increased investment in small C corporations and will reward those who patiently build up a successful business over a number of years. Unfortunately, the Administration's plan only permits C corporations to take advantage of a lower capital gains rate. Since only 20 percent of businesses in this country are C corporations and most new businesses are set-up as sole proprietorships, partnerships or S corporations, this proposal will have a very limited impact.

The President's plan also contains a variety of tax deductions and credits to help stimulate business activity. These stimulants include the research and experimentation credit, the targeted jobs tax credit, small issue manufacturing and agricultural bonds, enterprise zones and mortgage revenue bonds. However, these stimulants will not be strong enough to offset the depressing effect of $275 billion in new taxes.

<u>TAX PROVISIONS THAT WILL HINDER SMALL BUSINESS JOB CREATION</u>

Hitting the Self-Employed

Eighty percent of businesses in America are unincorporated and pay taxes as individuals. Increasing taxes on these individuals takes money out of their businesses that could be used to expand and hire more employees.

The taxable income of self-employed business owners is deceptive. They may have to pay tax on much more income than they take home as salary. These business owners must pay tax on <u>what the business earns after deductions, not just their salary</u>. For example, if a successful dress shop earns $500,000 and decides to expand inventory by purchasing $450,000 in additional clothing, the shop owner will pay tax on much more than just her take home profit of $50,000. Since she is only able to deduct the cost of the clothing when it is sold, she could end up paying tax on most of her $450,000 worth of inventory. As a result, the additional taxes listed above will seriously hamper her ability to expand the business even though she takes home a modest income.

President Clinton's economic plan increases taxes on the self-employed in five ways:

1 -- Income tax rates are increased from 31% to 36% for those earning over $140,000 and filing a joint return; $115,000 if filing as an individual or $127,500 if filing as a head of household.

In the example above, if the dress shop owner carried $200,000 of inventory from one year to the next, she would have to pay tax on $250,000 (since inventory is not deductible until sold, she will have to pay tax on her $50,000 salary plus the $200,000 in unsold inventory). If she was filing a joint return, the higher tax rate would apply to $110,000 (increasing her taxes by $5,500), even though she has already spent that money trying to make her business more successful.

2 -- The wage cap on the Hospital Insurance portion of FICA is eliminated, effectively raising the tax rate of self-employed business owners earning above $140,000 by 2.9%.

This is just another layer of taxation on a self-employed business owner. This change will require business owners to pay yet another 2.9% on any amounts they have to report as income that exceed $140,000.

3 -- The individual alternative minimum tax (AMT) is increased from 24% to 26% for those earning less than $175,000 and 28% for those earning more.

Increasing the alternative minimum tax hurts small business owners in two ways. First, it will increase the tax liability of those paying the AMT. Second, narrowing the gap between the AMT tax rate and the regular tax rate will force an additional number of business owners to calculate the tax even if they do not ultimately have to pay it.

4 -- The limitations on itemized deductions and the personal exemption (known as PEP and Pease) are extended, effectively raising the tax rate of those earning more than $160,000 by another 2%.

As shown in the examples above, the taxable income of a self-employed business owner can exceed $160,000 even if the amount of salary taken out of the business is relatively minor. This change in the law could require a business owner to pay an extra 2% tax on money that has already been spent to improve the business.

5 -- The business meal deduction is lowered from 80% to 50%.

Virtually every small business owner takes advantage of the business meal deduction. For many small business owners who are limited in the amount of advertising they can purchase, the business meals and entertainment can be one of the primary ways of attracting new business.

Successful business owners trying to expand their businesses are hardest hit by these changes in the tax code. However, these very same businesses are the ones that we will rely on to provide most of the new jobs in the coming years.

Deja Vu

This is not the first time since 1986 that the self-employed have been asked to increase their contributions. In 1990, several changes were made to the tax code that increased the tax liability of the self-employed:

- The top individual tax rate was increased from 28% to 31% for married individuals earning more than $78,400.
- Itemized deductions were limited.
- The Medicare HI cap was lifted from $53,400 to $125,000, effectively raising the marginal rate of self-employed individuals between those two incomes by 2.9%.

The same self-employed business owners who watched their taxes go up in 1990 are now being asked to contribute more again.

The Btu Tax

The Btu tax does not single out self-employed business owners in the same manner that the taxes mentioned above do, but NFIB members are still very concerned about the impact the Btu tax will have on their tax liability and on the economy as a whole. As a result of their being in business, small business owners consume more energy than the general public. As a result, they will pay a disproportionately high percentage of this tax. In addition, the Btu tax is not levied on businesses based on their ability to pay. A new energy intensive enterprise barely making ends meet could end up paying the same amount of tax as an older, more established enterprise that is very profitable.

Another concern is that a Btu tax will increase the manufacturing and transportation costs of every product, raising the specter of inflation. As we have seen in the past, inflation is the worst enemy of a balanced budget because of its impact on entitlement programs.

From a policy standpoint, NFIB members are concerned that the Btu tax is new and that it is hidden. New taxes raise enforcement problems, and it is difficult to gauge how they will affect the economy. A Btu tax is new not only to this country; no other industrialized nation has a Btu tax. In fact, some European nations have dismissed a Btu tax because they feared it would negatively impact their international competitiveness.

The cost of the Btu tax inherent in the price of a product is hidden from consumers. This is its most disturbing characteristic. NFIB members oppose hidden taxes because they believe they are too easy to increase in the future.

Increased Paperwork

The President's proposal also requires small business owners to complete additional

forms (IRS form 1099) reporting payments to other corporations. This will dramatically increase the amount of paperwork small businesses have to complete.

Business owners who make payments in excess of $600 per year to an individual in exchange for services must file a form 1099 with the IRS to report the amount paid. Payments made to corporations need not be reported. The Administration's proposal would change current law, requiring business owners to also report payments made to corporations for services. This proposal has several serious flaws, including the following:

- Form 1099 reporting paperwork could double or even triple for the average small business owner. This would force business owners to spend even more time filling out government paperwork instead of running their businesses.

- The information reported on form 1099 is useless to the IRS. The IRS's inadequate computer system prevents them from being able to match the 1099 forms they already receive.

- Some payments for services cannot be calculated. For example, if a business owner buys a copying machine from Xerox with a two-year service contract worth more than $600, what does the business owner report? The value of the service contract to the business? The cost of the service contract to Xerox? The entire purchase price, including the cost of the machine? Many small business owners will just report the entire purchase price to avoid any liability on their part and let Xerox and the IRS work out the details.

In sum, this change in the law will require business owners to spend additional hours filling out forms that are completely worthless to the federal government.

IMPACT OF THE PRESIDENT'S ECONOMIC PLAN ON THE 1986 TAX REFORM ACT

In 1985, this Committee labored mightily to accomplish three goals:

* Simplify the tax code to make it less mysterious to the average taxpayer;
* Eliminate tax shelters and loopholes to encourage investors to make business decisions independently of the tax code; and
* Lower the tax rates and broaden the base to make the code fairer to those unable to hire professional tax assistance.

All three of these goals were accomplished in the ensuing Tax Reform Act of 1986. Small business owners profited from the lower rates and the simpler rules. NFIB supported these changes. Increasing numbers of small business owners took advantage of the low individual rate by becoming S corporations. The Administration's proposal will eliminate many of the gains made in 1986.

The Administration's proposal brings back higher rates, special tax breaks, increasing complexity and individual rates that are higher than the corporate rate. Although many NFIB members are supportive of "change" in government, one thing they do not want to see change again is the tax code. According to a recent NFIB survey, frequently changing tax laws was a major problem facing small business. Changes in the tax code were more problematic than filling out federal paperwork or competition from larger businesses. The proposed changes will be particularly devastating for those business owners who became S corporations because of the changes made in 1986. The Administration's proposal inverts the corporate and individual rates. Now that corporations will pay a lower tax rate than some individuals, owners of S corporations must re-evaluate the benefits of being an S corporation.

MAKING THE PACKAGE FRIENDLIER TO SMALL BUSINESS JOB CREATION

As mentioned above, little economic evidence exists to show that our economy is in need of any stimulus. The economy is growing, large numbers of jobs are being created and business owners are ready to expand. Yet, even with all this good news the Administration is proposing $160 billion in new stimulus spending over five years. To pay for this new spending, it proposes raising taxes significantly on the very segment of society that creates new jobs -- small business owners. NFIB members strongly believe that if allowed to keep more of their own money, they could create more and better jobs than any government jobs program.

To this end, NFIB recommends the $240 billion in tax and spending stimulus be stripped out of the package and that $240 billion worth of tax increases be eliminated. This change will prevent the current recovery from being cut short by a sudden increase in the tax burden.

CONCLUSION

On behalf of the over 600,000 members of the National Federation of Independent Business, I ask this Committee and Congress to rethink the approach to economic growth and job creation. Taxing small business owners to pay for make-work government jobs programs may result in lower unemployment in the short term, but over time, the government jobs will evaporate, and we will find that we have deprived the private sector of the resources they need to hire these workers.

Mr. KOPETSKI. Mr. Gladstone, welcome.

STATEMENT OF DAVID GLADSTONE, DIRECTOR, NATIONAL ASSOCIATION OF BUSINESS DEVELOPMENT COMPANIES AND CHAIRMAN, ALLIED CAPITAL

Mr. GLADSTONE. Thank you, Mr. Chairman, I appreciate the opportunity to address this group. My association represents business development companies, and business development companies make loans and investments to small business. That is our only business, so we are very much interested in the health of small business. We applaud the President's proposal. We think it is a very good start and we are very interested in following the legislation and hope to better it with some of the suggestions we come up with today.

One of the things we would like to bring up which hasn't been mentioned by anybody is that increasing taxes on higher income individuals will actually hurt small business. Studies have shown that people who earn between $200,000 and $1 million a year, the so-called higher income people, are the source of approximately 90 percent of the risk capital that goes into new and growing small businesses.

Now, we are talking about billions of dollars of risk capital, not loans. This is the money that is used to start small businesses. During the past 4 years, the recession has dramatically reduced the income of this class of taxpayers and as a result there has been a corresponding drop in the risk capital for small businesses. New business formation has been at an all time low over the last 4 years.

In short, the United States just isn't forming small businesses. Small business is a source of approximately 80 percent of all the new jobs created in the United States and since the United States is not creating new businesses, there is no reason to think that there is a good outlook for job creation.

Taxing those who earn between $200,000 and $1 million will in essence shut down much of the risk capital that flows into small businesses today. We, in essence will stop many of the creations that should be going on if we want small business to continue to create business and jobs for the next century.

Changing the Tax Code will help some business development companies, as outlined in my written testimony, but that is not enough. We are talking about risk capital and billions of dollars and the 10-percent surtax placed on those who earn over $250,000 will in essence take a lot of the risk capital that would have gone to small businesses to start small businesses out of the hands of small businesses and of course into paying the deficit.

We think increasing the tax on individuals will be the single worst thing that we can do for risk capital for small business. We would encourage you to look toward a tax on consumption as opposed to a tax on investment.

Our second point is on capital gains, the President has proposed a modified version of what has affectionately been referred to as "the Bumpers bill" that was introduced last year as S. 368. The President's version of the bill does help some, but as mentioned by Mr. Motley, it just doesn't do the job. We need a complete bill that

will help put risk capital into small businesses and without the small business with risk capital, we are not going to create the jobs and we would encourage you to adopt the Bumpers bill in full, rather than only a part of the Bumpers bill.

There are some tax changes that will help my industry, the business development companies to also increase our activity in small business. Most of us operate under the Tax Code known as regulated investment companies. Regulated investment companies were in essence designed, that legislation was designed for mutual funds, and one of those rules is called the short-short rule, meaning that just for example a business development company makes a loan to a small business and decides to sell part of that loan, as they often do in order to syndicate business loans or business investments, it would cut against it, they would in essence flunk the short-short test and no longer be a regulated investment company and have a whole different world to live in rather than the one they were designed under.

The short-short rule was repealed in H.R. 11, which was of course vetoed by the President, and we would hope in your enactment this year that you will put a repeal of the short-short test into that new legislation. I might mention that Senator D'Amato and Congressman LaFalce are working on legislation to sell loans. Without the repeal of the short-short rule, the IRS rule will take a large number of players out of the marketplace for small business loans. I might mention also that this is revenue neutral, so it would be a big plus if we could get that.

There is another aspect that affects business development companies and that is the shortage of buyers of business loans over at the RTC and the FDIC, and that is primarily because of the asset diversity test that is in the Tax Code, that is, they may not have more than 50 percent of their assets in companies where their ownership is more than 10 percent.

If we want to clean up some of the small business loans at the RTC and FDIC, we would ask that you relax the asset diversity test on business development companies. Again, this will be revenue neutral and not have an impact on the taxes today.

Finally we would just throw in a word for the people in the real estate trust area. We need long-term loans and the source of loans for small businesses, we are not getting it from banks, we are not getting it from S&Ls. We think if you change some of the laws in the REIT area, there would be an opportunity for us to put more loans into the REIT industry. And this goes back, REITs are subject to the short-short rule test.

If the short-short rule can be repealed, for REITs, then those REITs might be more interested in making small business loans, and this comes about because of because if REIT makes a loan to a small business and then receives a prepayment in the first 4 years, that prepayment, any discount on the prepayment, can be counted against the REIT in meeting its short-short test.

All these things have been repealed before. We hope that they will be added to the President's bill and passed this time around.

Thank you very much for inviting me.

[The prepared statement follows:]

Written Testimony
of

David Gladstone
Chairman of Allied Capital
representing

The National Association of Business Development Companies
on

The President's
Revenue Proposals and
Other Small Business Issues
April 16, 1993

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1 SUMMARY

The National Association of Business Development Companies appreciates the opportunity to express their views on the Presidents Revenue Proposals. We want you to know that we strongly support the underlying objectives of this legislation where it is designed to promote capital formation and aid to small business. We know from our experience that small businesses are the cornerstone of the U.S. economy and their growth and prosperity generates most of the new jobs created in the United States. We also understand that access to financing in the securities market as well as through banks and other third party lenders can be enhanced by reducing regulatory burdens.

2. BACKGROUND ON ALLIED CAPITAL

Allied Capital Corporation and its sister company Allied Capital Corporation II are two of the few Business Development Companies (BDC's)[1] in existence today. These companies are chartered and licensed only to make small business loans and investments and have no other reason for being in existence. Both of these companies are traded on NASDAQ and both are well received by the public as publicly traded companies that help small business.

3. COMMENTS ON THE CURRENT "CREDIT CRUNCH"

In 1974-5 when I was making loans to small businesses, credit availability was terrible. There were no loans available. In 1981-2 when interest rates were sky high, credit for small business was non-existent. Both periods were tough times for small business. But both the BOD periods pale by comparison to the credit shrinkage of 1991-3. There is almost no credit available to small business today. The landscape for small business credit is a wasteland. Businesses are starving for funds.

What is causing this "Credit Crunch"?

There are several items one can point to. In my opinion banks are not lending because of regulations and litigation. There are too few non-bank lenders.

1. Regulation is Killing Bank Loans

The regulators have imposed so many conditions on a banks new loans that it stops all loans. I sit on the board of a Bank and if the that bank followed everything the regulators proposed, the Bank could not

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[1] BDC's were created to be separate and apart from mutual funds by he Small Business Incentive Act of 1980 ("1980 Act")[Pub.L. No.96-477], as a category of venture capital companies subject to separate and distinct provisions of the 1940 Act designed to recognize their distinct characteristics. A BDC is a special closed-end management investment company with securities requested under Section 12 of the Securities Act of 1934, and is operated for the sole purpose of making specific types of investments to small businesses.

make a new loan. In short, the bank regulators have regulated small business loans out of existence. What loan officer wants to stand before a board of directors of a bank and answer to a regulator who tells the board that the loans office is not in compliance with the regulations. Even though the regulation is one that says he didn't get the real estate appraisal within 30 days of dispersing funds. Or what loan officer wants to be accused by the bank regulators of "relying too much on character" to make a loan!

No loan officer, who has a spouse and children, who depend on the paycheck, will risk their job to make such a loan.

2. Litigation is destroying Lending

Litigation is a way of life for every loan officer in America today. This sweeping statement is the literal truth. Every loan officer who has been making loans since the eighties has been involved in litigation because borrowers now sue the banks they borrow money from, making outrageous claims against the banks; all in leu of repaying their debts to the bank. This has left loan officers in a "shell shocked" state of mind, and unwilling to make new loans for fear of creating another frivolous lawsuit. An entire generation of loan officers have been demoralized and negatively trained not to make loans.

Loan officers cannot function in today's legal climate because lending is predicted on the "good faith" of the borrower. There can be no good faith relationships when one party (the banker) is always "looking over his shoulder" for a possible lawsuit.

The astronomical number of lawsuits exist today because lawyers can file frivolous lawsuits with no consequence to their client or themselves. This litigious climate has shut down lending by thousands of loan officers. As long as lawyers are permitted to make frivolous claims in court in hope that a jury will believe at least some of the claims and make an award of something to them, then, loan officers will not lend. The point here is that if the jury doesn't side with the plaintiff then its no big loss to the law firm.

Congress must pass a law that will allow defendants to recover from plaintiffs all legal and out of pocket expenses, if the plaintiffs loose their suit. Its the only law that will restore order to the lending marketplace. Every civilized nation in the world has this rule except the U.S.. We need this law in order to turn the flow of funds back on to small businesses. I beg you to consider legislation in this area.

3. There are too few non-bank lenders

Currently there are too few institutions that will lend money to small businesses when banks are not in business of making those loans. As we know banks are out of the business of making all but a few small business loans. This has caused the current credit crunch. One solution to alleviating the need for capital and small businesses is to help Business Development Companies and Small Business Investment Companies grow by eliminating the regulations that currently keeps them from making loans and investments to small businesses and raising money in the stock market. By eliminating the regulations that currently hamper Business Development Companies the United States Government is making it impossible for additional financial institutions to grow and prosper. these new institutions could be the institutions that will make loans and investments to small businesses. We think that the new proposed law entitled, "The Small Business Incentive Act of 1993", will take a giant step in the direction of encouraging non-bank financial institutions to come forward and since these institutions are for making loans to small businesses it will help the marketplace by providing credit. While all the provisions of the act are not as liberal as they could be, the law is a step in the right direction and we urge that the Senate go forward with this law.

4. **COMMENTS ON THE PRESIDENTS REVENUE PROPOSALS**

I REVENUE REDUCTION PROVISIONS

I-A Training and education

The associations and its member are in favor of the permanent extension of employer provided educational assistance and the permanent extension of job targeted tax credits.

I-B Capital Investment and Economic Growth

1. ITC

We are in favor of a general investment tax credit that will help any business save taxes and invest for the future. The fact that this has been limited to "small" businesses may be a mistake since the definition of "small" business in the President's proposal is "a business with average annual gross receipts of less than $5 million in the three years preceding the taxable year". This is another definition of small business and should not be used in the proposal. Instead the proposal should use the definitions used by the U.S. Small Business Administration which is "any business with less than $6 million dollars of net worth and less than $2 million dollars in after tax profits in the preceding year." The U.S. Small Business has spent millions researching and defining "small" in small business. We don't need another definition. We recommend the proposed legislation be changed to include the best definitions of small business.

2. R & E Credit

We are very happy to see the President's proposal would permanently extend research tax credits and we applaud that.

3. Capital Gains

The capital gains exclusion for certain small business stock is not adequate. The President's proposal is modeled on the "Bumpers Bill" an extremely well thought out and perfectly crafted in language bill as put forth by Senator Dale Bumpers. We would ask that the administration review the Bumpers Bill and adopt it in its entirety with regard to Capital Gains exclusion for certain small business stock. The Bumper Bill has cost millions to design and formulate. It is complete and should be adopted. The Bumper Bill is "S368".

4. ATM

No comment on modifying ATM depreciation schedule.

5. Bonds

No comment on bonds for high speed rail facilities

6. Permanent extension of qualified small business bonds.

We applaud the Presidents proposal to permanently extend the authority to issue qualified small issue bonds.

I-C Enterprise Zones

We applaud the President's desire to designate 50 federal Enterprise Zones which would benefit from targeted employment investment incentives. This is the right thing to do.

I-D Tax Credits

We agree with he President's proposal to expand and simplify the earned income tax credits.

I-E Real Estate Investment Provisions

Generally we do not have comments on every item but we do on the following.

1-4 No Comment

5. Facilitate real estate investments by pension funds and others.

We believe that relaxing restrictions on debt financed real estate investments by pension funds and others will free up capital to allow small businesses to be able to buy their own real estate. We also believe that repealing rules regarding publicly traded partnerships will also allow more funds to come into real estate and benefit small businesses. Further we believe that title holding companies to receive small amounts of UBIT will be beneficial to small businesses that need to raise capital. As will excluding loan commitment fees and certain option premiums from UBIT.

I-F Other Provisions

We are in favor of the temporary extension of health insurance deductions for self-employed individuals. As the committee well knows, most small businesses are unincorporated and this is a part of the law that should be kept in force.

II. REVENUE RAISING

II-A Individual Taxes

1. Increased taxes for higher income individuals.

A. Small businesses in the United States are not in favor of individual income tax increase as set forth in the President's proposal. Increasing income taxes will not create jobs in the small business sector. Most small businesses are "sub-S" companies or are unincorporated businesses, so therefore the tax increase will be a direct tax increase on the small businesses. The tax increase will cause small businesses to try to pass on the increases tax to its customers, or worse, not hire additional people because they are paying higher taxes and don't have the money for new employees. We think that the revenue raising provisions contained in the individual income-tax side will be very detrimental to small business and small business hiring. A general exemption should be made for small businesses.

Generally speaking small businesses would be much more in favor of a consumption based tax, than a tax on profits. We would encourage the committee to consider consumption taxes as opposed to income taxes.

B. We would like to note that the increased taxes on high income tax payers and the alternate minimum tax rate will all cause small businesses to have to incorporate as regular "C" corporations so that they may keep the profits inside the business as opposed to having the profits flow through to the individuals (where taxes are to be higher) and then reinvested back in the business. This will cause them additional work to incorporate in states and file additional paperwork. We would hope that with regard to small businesses surtax on high income tax payers and alternate minimum taxes that these taxes could be relaxed where a business is involved as opposed to an individual's earning salary.

C. The small business community is made up of small businesses that can grow on their own capital and those that need raise capital to grow. In the current climate there are three sources of capital. (1)Banks, (2)non-bank financial institutions like Business Development Companies and (3)"wealthy individuals". These three sources have different attributes. The first source, Banks, currently doesn't have a great deal of money for small businesses and no amount of freeing up that money will make that money be available for risk taking. If banks can lend to small business then a small business will be able to borrow money to buy machinery but it will not be able to borrow money from a bank to start a business or take on a high risk proposition such as a new product.

Non-bank financial institutions generally take more risk but they are in such short supply that there is not enough money to go around to the small business community. (Incidently, a new bill introduced by Senators Dodd, D'Amato, and Riegle called the "Small Business Incentive Act of 1993" would go along way to create more non-bank financial institutions [2])

The third source of funding for small business is "wealthy individuals". Generally speaking these "wealthy" individuals are not the "mighty titans" of industry that earn more than a million dollars a year but rather "wealthy" individuals that earn from $200,000 to $1 million dollars per year". These individuals which we term "wealthy" but not rich are individuals who themselves have had a string of good luck in business and are willing to invest in other people to see if they can do better. By increasing the tax on this group of "wealthy" individuals it will limit the funds going to small business. Here's

[2] See below Item number 5-V for further informaton on this bill.

why.

Wealthy individuals who earn from $200,000 to $1 million are the predominant source of risk capital for small businesses. While everyone talks about venture capital (which is the business name for Business Development Companies) in truth there is only approximately $35 billion of venture capital available in the United States today. This is documented by Venture Economics - the standard magazine in this area.

Since there is only $35 billion dollars of venture capital available and much of it is already invested, where do small businesses get there money from? They get it from wealthy individuals (not rich ones). These funds come in the form of $20,000 - $50,000 stock purchases by wealthy individuals who want to "take a flyer" on investing in a small business. Hundreds of thousands of small businesses in the United States get money form wealthy individuals each year. It is estimated by the experts on this source of money that 95% of the risk money supplied to small businesses comes from these wealthy individuals. It is no wonder that they have been given the slang name of "Angels" since they are the primary source of all goodness for small business. Without these Angels there would not be small business community today.

Therefore it is very obvious that a tax increase on these wealthy individuals will be a direct hardship on small businesses. It will dry up capital, remove money that is desperately needed by these small businesses and foster a climate of "no risk dollars available" for small businesses.

During the 1980's small businesses were fueled <u>not</u> by great bank loans (although that helped) <u>not</u> by venture capitalists (although there was plenty of venture capital) but primarily by Angels founding and financing small businesses with loans and investments of $20,000 - $50,000 dollars. A classical study on this has been written by Wetzel [3]. By increasing the tax on Angels the United States Government will remove much of the seed capital that would go to small businesses. By taking money away from Angels Congress will remove it directly from the mouths of small business. In plain farming terminology this is like "eating your seed corn".

Of all the provisions being proposed by the President , this provision of increasing taxes on individuals whose income is from $200,000 to $1 million dollars will be the most damaging to small business. It will literally destroy the seed capital needed to grow the next generation of small businesses. We ask this Congress not to do this.

2. <u>Repeal health insurance wage base cap.</u>

The repeal of the wage base cap will hurt small businesses most since they are unincorporated businesses and this proposal will be a direct tax. We recommend an exemption for small business.

3. <u>through 8.</u>

No comment.

II-B Business Provisions

No Comment

II-C Foreign Tax Provisions

No Comment

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[3] Wetzel, W. 1983 <u>Angles and Informal Risk Capital</u> and see also Haar, N. 1992 <u>Informal Risk Capital Investors</u>.

II-D Energy Tax Provisions

No Comment

II-E Compliance Provisions

No Comment

II-F Miscellaneous Provisions

No Comment

III ADDITIONAL PROVISIONS

III-A Increase taxable portion of social security.

We believe that increasing the taxable portion of social security is another form of taxes that will reduce that money available in small business to finance their growth. Therefore we would hope that the house would not enact the President's Bill.

5. <u>PROVISIONS THAT SHOULD BE ADDED TO THE PRESIDENT'S BILL</u>

I. <u>Repeal Regulated Investment Company "Short-Short" Test</u>.

We urge that current law be amended to repeal the so-called "short-short" test for Business Development Companies that qualify as regulated investment companies ("RICs"), which unnecessarily burdens RICS and poses a constant risk of inadvertently losing RIC status. In order to qualify as a RIC for Federal income tax purposes, a corporation must satisfy certain qualification tests, including a test known as the "short-short" test. Under section 851(b)(3) of the Internal Revenue Code, a corporation cannot qualify as a RIC if 30 percent or more of its gross income is derived from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held for less than three months.

The short-short test has been defended as protecting RIC investors against "churning" and risky short-term trading activities by RICs. However, the securities laws adequately serve these purposes of protecting investors. Moreover, the short-short test may actually increase investors' risks because the test sometimes forces RICs to hold appreciated stock or securities that are losing value and restricts RICs' ability to use options in hedging transactions to protect unrealized gains against loss. The short-short test also forces RICs to monitor the holding periods of its assets and keep track of short-term gains it realizes through the year, thereby burdening RICs with significant recordkeeping, compliance, and administrative costs.

The repeal of the short-short test was included in H.R. 11, which was vetoed by President Bush last year. The repeal of the short-short test has been included in H.R. 13, introduced by Chairman Rostenkowski this year. We urge that the repeal of the short-short test be included in any tax legislation to be enacted this year.

We also wish to recommend that the repeal of the short-short test be made retroactive to tax years ending on or after the date H.R. 11 was passed by the Congress. WE do not wish to suggest that RICs should be forgiven for intentionally violating a requirement of the Internal Revenue Code. However, a RIC that violated the short-short test would only have done so inadvertently. Moreover, there are some areas of uncertainty regarding the proper scope of the short-short test. Many types of income that are not derived from speculative short-term trading activities may be considered subject to the short-short test by the Internal Revenue Service. We therefore strongly urge that the repeal of the short-short test be made retroactive to take effect as it would have had H.R. 11 not been vetoed last year in order to eliminate the unduly harsh result of an inadvertent violation. This limited retroactivity would not have a significant revenue impact and would not reward

any RIC for an intentional violation of requirements of the Internal Revenue Code.

This provision is revenue neutral.

II. Asset Diversity Test for Business Development Companies Purchasing Loans From the RTC and FDIC.

We urge that the asset diversity test applicable to RICs in section 851(b)(4)(A) of the Internal Revenue Code be modified to facilitate the purchase of small business loans from the Resolution Trust Corporation ("RTC"), Federal Deposit Insurance Corporation ("FDIC") and similar government agencies by RICs that have elected to be treated as "business development companies" ("BDCs") under the Investment Company Act of 1940 and to any securities subsequently acquired through the foreclosure or restructuring of such loans.

In order to qualify as a BDC under the Investment Company Act of 1940, an investment company must provide capital to small companies and financially troubled companies. BDCs specialize in making and servicing loans to small businesses and have purchased small business loans from the RTC and FDIC. The small business loans held by the RTC and FDIC are not being properly serviced, as they would be if they were held by a financial institution. Current law, however, unnecessarily limits the ability of a BDC to purchase such loans and provide proper servicing.

Section 851(b)(4)(A) of the Internal Revenue Code provides that at least 50 percent of the total assets of a RIC must be represented by "qualifying assets" such as cash, government obligations, securities of other RICs, and other stock and securities. In counting "other" stock and securities towards the 50 percent of assets test, a RIC may not count the stock or securities of any one issuer (other than the Government or another RIC) if such stock and securities constitute more than five percent of the total value of the assets of the RIC. Similarly, a RIC may not count the stock or securities of any one issuer (other than Government securities or the securities of another RIC) if the RIC holds more than ten percent of the outstanding voting securities of the issuer. These asset diversity requirements discourage BDCs from purchasing small business loans from the RTC or FDIC for the following reasons.

First, BDCs, which specialize in making loans to small businesses, are not large mutual funds, but are relatively small closed-end investment companies. The value of some of the small business loans held by the RTC and FDIC exceeds five percent of the total value of such BDCs and therefore would not constitute qualifying assets for purposes of the 50 percent of assets test.

Second, a foreclosure on a secured loan may result in the BDC receiving substantially all of either the equity securities of the debtor or the debtor's operating assets. If the BDC receives substantially all of the equity securities of the debtor, it will hold more than 10 percent of the debtor's voting securities and such securities will not be qualifying assets for purposes of the 50 percent of assets test. If the BDC receives the debtor's operating assets, the BDC would have to transfer the assets to a new wholly-owned subsidiary of the BDC[4] with the result that the BDC would own 100 percent of the subsidiary's voting securities so that the securities of the new subsidiary would not be qualifying assets for purposes of the 50 percent of assets test. The possibility that a BDC will be forced to foreclose on a loan purchased from the RTC or FDIC is often greater than normal because such loans are often purchased without complete loan documentation.

Finally, the restructuring of a loan purchased from the RTC or FDIC to avoid foreclosure may nonetheless result in the debtor satisfying a substantial portion of its obligation with voting securities that would not constitute qualifying assets because they exceed ten percent of the debtor's outstanding voting securities.

[4] A RIC cannot directly operate a business directly because 90 percent of its income must be in the form of interest, dividends, and gains from the disposition of stock or securities. Therefore, a RIC must put operating business assets into a subsidiary.

Therefore, in order to encourage BDCs to purchase small business loans held by the RTC and FDIC, we urge that the asset diversity test under section 851(b)(4)(A) be liberalized for loans purchased from the RTC and FDIC (and securities acquired in restructuring or foreclosing on such loans). Congress has previously liberalized the asset diversity test in order to help "high-tech" start-up companies attract venture capital. Under section 851(e), the five percent of asset value limit of the asset diversity test is slightly liberalized and the ten percent of voting securities limit of the asset diversity test is eliminated for RICs that provide capital to "high-tech" start-up companies.[5] In order to encourage the purchase of small business loans from the RTC and FDIC, we urge that a similar liberalization be provided for loans purchased by BDCs from the RTC or FDIC and to securities acquired in foreclosures or restructurings of such loans. Such a liberalized asset diversity test would eliminate the ten percent of voting securities limit and would increase the five percent of asset value limit to ten percent to facilitate the purchase of such loans by BDCs, which are generally small companies.

We propose that the liberalized asset diversity test apply to loans purchased by BDCs because BDCs are the only type of RIC that specializes in making capital available to small businesses. We believe that liberalizing the asset diversity test for BDCs is the most effective way to encourage the purchase of small business loans by RICs from the RTC and FDIC.

This provision is revenue neutral.

III. Limitations on Investments in REITs by Pension Trusts.

We urge that current law be amended to make it easier for pension trusts to invest in real estate through REITs. In order for a corporation to qualify as a REIT, not more than 50 percent of the value of the outstanding stock of the REIT can be owned by five or fewer individuals (the "5/50 rule"). Current law treats a domestic pension trust as a single individual for purposes of this rule. Therefore, a REIT is restricted in its ability to raise capital from pension funds. The treatment of domestic pension trusts as single individuals for purposes of the 5/50 rule is especially burdensome for smaller REITs because many pension trusts have a policy of not investing amounts that are less than a specified minimum amount, which may represent a substantial ownership interest in a relatively small REIT. WE urge that section 856(h) of the Internal Revenue Code be amended to treat the beneficiaries of a U.S. pension trust as the holders of REIT stock owned by the pension trust for purposes of the 5/50 rule. This will provide money to small businesses that want to buy real estate to expand their business. These funds do not exist today.

Bills introduced by Representative Andrews (H.R. 749) and Senator Boren (S. 342) would amend section 856(h) to provide that a pension trust generally is not to be treated as an individual for purposes of determining whether five or fewer individuals own more than 50 percent of the value of outstanding REIT stock. Under the bills, the beneficiaries of the pension fund would be treated as the owners of REIT stock held by the pension fund. The bills would also provide that if a corporation qualifies as a REIT by reason of treating pension trust beneficiaries as the owners of stock held by the pension trust and if the corporation is a "pension-held" REIT, a portion of the dividends paid by the REIT to the pension funds would be treated as income from an unrelated trade or business. This rule would apply only if at least five percent of the REIT's income would have been unrelated trade or business income in the hands of a pension fund, and would apply only to pension funds that own more than ten percent of the REIT. The same amendments to section 856(h) were included in both H.R. 4210 and H.R. 11, which were vetoed by President Bush last year.

The amendments to section 856(h) contained in H.R. 749 and S. 342 that would relax the limitations on investments in REITs by pension funds would remove unneeded restrictions on the ability of pension trusts to invest in real estate through REITs and would help smaller REITs gain

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[5] To prevent RICs from becoming holding companies, this liberalized asset diversity test is not available for the securities of an issuer if the RIC has held any security of the issuer continuously for ten or more years. Moreover, the liberalized asset diversity test is not available to a RIC that has more than 25 percent of its assets invested in the securities of issuers in which the RIC holds more than ten percent of the outstanding voting securities and in respect of which the RIC has continuously held a security for ten or more years.

access to needed capital. Accordingly, I urge that section 856(h) be amended as proposed in H.R. 749 and S. 342.

This provision is revenue neutral.

IV. Exclude Mortgage Prepayments From the REIT Short-Short Test.

We urge that current law be amended to exclude from the REIT "short-short" test any gains realized upon the prepayment or refinancing of a mortgage that was either originated by the REIT or was a "performing" loan when purchased by the REIT. Under section 856(c)(4) a corporation will not qualify as a REIT for any taxable year in which thirty percent or more of its gross income is derived from the sale or other disposition of (1) stock or securities held for less than one year, (2) properties that are held primarily for sale to customers or that constitute inventory in stock or trade, and (3) real property (including interests in real property and interests in mortgages on real property) held for less than four years. This rule corresponds to the short-short test for RICs, and is meant to limit the extent to which REITs engage in active trading of real property and mortgages on real property.

The prepayment of a mortgage with original issue discount or market discount within four years of being purchased by a REIT results in the realization of gain by the REIT, which can result in the loss of REIT status. The danger of losing REIT status due to the prepayment of mortgages needlessly discourages REITs from originating mortgages with original issue discount or purchasing performing mortgages with market discount. The underlying purpose of section 856(c)(4) is to insure that REITs will hold real property and mortgages on real property as investments and will not actively trade such property. Applying the short-short test to gains recognized upon the prepayment of mortgages that were originated or purchased as investments does not further the underlying purpose of the test.

Application of the short-short test to gains realized upon the prepayment of mortgages is especially burdensome in the case of mortgages purchased from the Resolution Trust Corporation ("RTC") and Federal Deposit Insurance Corporation ("FDIC"). Performing mortgages held by the RTC and FDIC are commonly sold at a discount because of a lack of complete loan documentation, which obliges a purchaser to make its own credit investigation of the mortgagor. The mortgages held by the RTC and FDIC are not always serviced as well as they would be if they were held by a financial institution. The short-short test in section 856(c)(4), however, discourages REITs from purchasing more than a limited amount of such mortgages. Since mortgagors have the right to prepay their mortgages at any time without the consent of the mortgage holder, a REIT must limit its holdings of discounted mortgages that have been held for less than four years in order to insure against the loss of its REIT status from the prepayment of such mortgages.

For purposes of the amendments we propose, a "performing" mortgage would include any mortgage as to which no scheduled payment was more than 90 days past due at the time of the purchase.[6] A "prepayment" would include any payment of principal that is made by the mortgagor pursuant to the terms of the mortgage. Thus, a "prepayment" would include partial prepayments and prepayments in full upon the sale or refinancing of the property. If the REIT refinances the property, the term "prepayment" should also include the issuance of a new mortgage in exchange for the old mortgage. In determining the holding period of a new mortgage received in exchange for an old mortgage for purposes of section 856(c)(4), the holding period of the old mortgage should be tacked on to the holding period of the new mortgage.

The amendments we propose to section 856(c) would apply only to mortgages that are originated by the REIT and mortgages that are "performing" mortgages when they are purchased by the REIT, and thus would not encourage the formation of so-called "vulture REITs". The amendments would apply to only gain recognized upon the prepayment or refinancing of a mortgage because such gain does not represent the type of short-term trading profit that section 856(c)(4) was intended to limit.

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[6] The RTC and FDIC do not always promptly inform mortgagors that the RTC or FDIC has taken over the assets of a failed thrift institution. Thus, some mortgages held by the RTC and FDIC have a few payments past due because the mortgagor has not yet been informed where to send the mortgage payments. Thus, any mortgage held by the RTC, FDIC, or similar financial institution should be considered a "performing" mortgage if no payment is more than 90 days past due.

This provision is revenue neutral.

V. **SUPPORT "THE SMALL BUSINESS INCENTIVE ACT OF 1993" FOR CAPITAL FORMATION**

Senators Dodd, D'Amato, Riegle and others have introduced "The Small Business Incentive Act of 1993" in order to stimulate capital formation. This new bill will remove some of the regulations of the Securities and Exchange Commission ("SEC"). The SEC commissioners have voted in favor of the bill. This bill will increase the flow of capital to small businesses. This bill is revenue neutral.

6. **SUMMARY**

In general we support the President's proposals but there needs to be changes.
There are some key proposals in the President's list of proposals that will not help small business. They are:

1. Increasing the tax on individuals who make $200,000 to $1,000,000 will destroy the flow of funds to small business. We cannot afford to slow down this flow.

2. The small business size defined in the President's proposals should not be used and in its place the proposal should use the definition of small business as established by the U. S. Small Business Administration.

3. The capital gains provisions of the Presidents Bill should be amended to include all of the provisions of the Bill introduced by Senator Bumpers.

4. The "Short-Short" test should be repealed so that Regulated Investment Companies don't accidentally fail to qualify as RIC'S.

5. The asset diversity test should be modified to facilitate the purchase of small business loans from the RTC and FDIC.

6. Pension trusts should be allowed to invest in REIT's beyond the 50% rule.

7. Exclude mortgage prepayments from the REIT's "Short-Short" test so they have better control of their ability to qualify as REIT's.

Mr. KOPETSKI. Thank you, Mr. Gladstone.

We asked the Secretary of the Treasury, Mr. Bentsen, the other day about whether he was open to including some of those provisions in H.R. 11 in the President's package, and he said that discussion was premature.

In your written testimony, you argue against the repeal of the cap on taxable wages for the Medicare tax. You suggest an exemption for small business people.

This tax increase would affect those with more than $135,000. What portion of small businessmen make more than that?

Mr. GLADSTONE. It depends on how you count it. If you count those small businessmen that are subchapter S and that are in essence unincorporated, I would say there is a large proportion of those small businesses that make more than $135,000 because simply the bottom line of the small business tends to be the income those people take home every day.

I don't have a percentage. I would be glad to look that up and provide it to you.

Mr. KOPETSKI. Mr. Motley might be able to help me out, because I thought we were only talking about 1.2 million of the 118 million employed people in the United States would be affected by this provision.

Mr. MOTLEY. I think the problem with the Tax Code is the way it treats different types of businesses, whether it is the way the business is structured or whether it is the type of business it is in, retail, construction, et cetera.

On page 3 of our testimony, we give an example where we see the greatest impact in the retail industry, where a retailer who invests their income during the year will be taxed on that if they haven't sold the inventory. They could make $500,000 during the course of the year, reinvest $400,000 in their income and only take $50,000 out of the business with $50,000 in other deductible expenses, and be taxed on the $450,000 where they are only taking $50,000 home.

To allow them to move to cash accounting would help alleviate that situation. I think that is the most egregious example where you would find this proposal particularly difficult for small businesses to deal with. It is not that they are taking home a lot of money. They have a lot of taxable income because it remains in the business.

Mr. KOPETSKI. Before I move to Mr. Crane I want to comment on Mr. Feldstein's testimony where he talked about the President's plan would produce little or no additional revenue and the Secretary of the Treasury, Mr. Bentsen, who is known for his fiscally conservative estimates, thinks this would raise $126 billion over 6 years and our Joint Committee on Tax, which is even more conservative than he is, says it will raise $112 billion.

There is a obviously a great gap there between one economist, two economists and a third economist.

Mr. Motley, you may want to talk to your economist and see what he or she has to say about those estimates.

Mr. Crane, you may inquire.

Mr. CRANE. Thank you, Mr. Chairman.

I want to congratulate you all on your testimony. Dr. Feldstein left. I wanted to address an initial question to him, but I will address it to the panel.

One of the big concerns I have is the one addressed by Mr. Donohue more than the rest of you dealing with that energy tax, first of all the discrimination in how it applies especially with natural gas versus oil; and secondly whether it is your conviction that your businesses, except those in the export business, are going to be so adversely affected or does that not ultimately hit every single person in our economy?

I am talking about food costs, the cost, for example, of farm machinery, the labor cost input, the transportation cost input, the processing input, the packaging input. This means that when a can of beans comes down the checkout counter that the consumer is picking up the tab.

What I find so disturbing about this is every time we have applied sales taxes, we have always exempted basics. Food is exempted, medical prescriptions, but all those costs have to ultimately be passed through and you have to get a fair return on investment or you are out of business.

Isn't this one of the most regressive discriminatory forms of taxation conceivable?

Mr. DONOHUE. Mr. Crane, I like your last few words. Those are exactly the ones we have been saying.

If you look at the 54 percent of the families and small businesses that make less than $30,000, their share of their income that will go to excise taxes under the discussions before us or even now, the same percentage is twice what it would be for people making between $30,000 and $60,000 and 5 times what it would be for people making over $60,000.

People say the energy tax only gets you for 8 cents. I say that is $3 billion in an industry that made $5 billion last year. You have to add in the other, the clean air—we are going to put in 7 cents, the 5 cents we got a few periods ago. You can't look at it and say "That is just the trucking guys. We will work that out," because you are so correct.

Those costs eventually increase the price of a product that we put on the international market, because we have cut it down. Our logistics system is so efficient in this country that if we ran at an average cost of the other countries, the cost of products we sell on the international market would go up 5 percent.

What we are trying to say is "Everybody is going to chip in, okay, but let's be fair." Whoever came up with this multiplier and said that petroleum would be multiplied 2.5 times more than other fuels, ones we are talking about, figured they had a patsy and the fact of the matter is that there are 7.8 million people in that business alone, not to mention the 34 million people among together the AAA, all these folks that are out driving around every day, and those folks will carry the burden and the majority of them are very low-income folks and they don't have a choice.

A carpenter in your State that has to drive 85 miles to work and back has to drive and it is going to cost him.

Mr. CRANE. I have people in my district commenting that with that hike they won't be able to take the commuter train to Chicago

or drive; they were going to have to buy a bicycle. I reminded them there are a heck of a lot of Btu's in constructing a bicycle. This hits ultimately those people who can least afford it.

Mr. MOTLEY. Last week—the chairman of our board has a company which some of you might recognize, Herrs Potato Chips or snack foods. They are the largest independent snack food manufacturing firm in the country. They compete with Frito Lay, Budweiser, PepsiCo. Their quick estimate of their increase in taxes on gasoline alone is $156,000 for next year.

They can't calculate their complete tax increase because they don't know how it will affect the purchasing of other types of fuels or energy. They estimate their taxes are going to go up at least 15 percent. With the competitors they have, they are very worried about where that is going to place them vis-a-vis large corporations as PepsiCo and Budweiser.

Mr. DONOHUE. If we cut the cost of that fuel energy tax down to an equal number, which would cut ours in half roughly, that would be $65,000 instead of the $120,000.

Mr. CRANE. Ultimately all those have to be passed on to consumers and you have to stay alive or you are out of business.

Mr. MOTLEY. That is right.

Mr. BLOOMFIELD. I would like to make four comments on the energy tax. The first is the fairness issue.

Mr. Reischauer testified before the Senate Energy Committee a week or so ago. There is an attempt being made in the Senate to substitute a value-added tax for a Btu tax. Mr. Reischauer said, one possible advantage of a VAT over an energy tax is that it would be less regressive because a disproportionately larger share of expenditures of low-income families are for energy and the energy tax is more of a burden on low-income families than a broad-based consumption tax.

Second, when Secretary Bentsen testified before this committee, he claimed that it would reduce the deficit.

As I understand the numbers, the Btu tax would raise about $30 billion a year, but it actually nets about $10 billion a year because you have a loss because of the deductibility of that tax against corporate income taxes and excise taxes.

In addition, the administration is providing $10 billion a year for the earned income credits. So if you are talking about reducing the deficit through the regressive Btu tax, I suggest that might not be the most efficient way to do it.

Third, Secretary Bentsen testified that it would reduce dependency on foreign oil. In the short run, economists believe that the demand for foreign oil is inelastic. You are not going to stop buying foreign oil. You will end up depleting domestic reserves which would make us more vulnerable to an energy crisis, if it comes to that.

Finally, as far as taxing pollution, as one of the other witnesses pointed out, there are other fuels which have a higher pollutant factor, carbon for one, which obviously were taken off the table.

We want to be fiscally responsible, but we want to do something good for the economy and a broad-based consumption tax is a better way to raise money.

Mr. KOPETSKI. Mr. Hoagland may inquire.

Mr. HOAGLAND. Thank you, Mr. Chairman.

I would like to welcome the four of you to the committee. We appreciate your patience waiting until Mr. Reischauer was completed.

During Mr. Reischauer's testimony, he indicated that the temporary investment tax credit for corporations of over $5 million would cost about $12 billion in the 2 years that it will last, and the 3 or 4 years that its economic effect will be felt.

My question is would it be a good policy decision for the Congress to spend that $12 billion in that fashion or would it make more sense to direct it to the deficit or would it make more sense to reduce the proposed increase in corporate taxes from 2 to 1 percent or would it make sense to direct it to the Bumpers proposal or some of the other proposals?

I would be interested in the views of each of you.

Mr. MOTLEY. Mr. Hoagland, in our testimony, one of the things we suggested that could be done to improve the package would be to take the various stimulus elements which we count up over 5 years to be $240 million and delete them and not raise taxes that much. We believe that the small business sector in particular is very tax sensitive and that being as flexible as they are that they are going to react in a way you are not going to want them to react.

I would broaden it beyond the 2 percent increase in the corporate rate. I would say take a look at all the stimulus. I don't think we need it right now.

Mr. DONOHUE. I believe that if you look at the investment tax credit, it gives you a great idea of how a magician works. It is great sleight of hand. You talk of 7 percent and by the time we start changing the types of equipment and products that are exempted or not allowed and we reduce the outyears and how long it lasts. It is down to 1 percent. But if it has $12 billion in it and you were to put that against the energy tax, you could significantly reduce that tax and save people all over this country the significant economic pain without all the paperwork.

Mr. BLOOMFIELD. Congressman, it seems to me to answer that question we have to first focus on what the objective is. My test with all these proposals is their impact on investment. I start out with a premise which I think is true, and that is that we tax saving and investment more than any other country.

One of the things other countries have is a value-added tax. I have in front of me a chart by the OECD. Our percentage of tax revenue from investment and saving is much higher. Our percentage of tax revenue from consumption is much lower.

Having said that, you are giving me a devil's choice, because the corporate income tax is obviously one way to address that bias. But having said that, I should note that Stanford Professor John Shoven analyzed a number of tax provisions to determine the most effective way to reduce the cost of capital for investing in machinery and equipment.

His analysis showed the most effective tax provisions were expensing, a good investment tax credit, not the one we are talking about here, and integration of corporate and individual taxes, with corporate rates being a lesser choice because corporate rates are basically a tax on the return on old investment.

Mr. HOAGLAND. So your answer is that there are a variety of ways that we could spend that $12 billion better, in your opinion?

I don't hear you defending the existing proposal by the administration.

Mr. BLOOMFIELD. My bottom line on the investment credit proposal of the administration is you don't get much economic punch.

When I talked with the administration, I suggested five tests for an effective investment tax credit and their proposal doesn't meet those tests.

Mr. GLADSTONE. We concur in the idea that the stimulus element is not a big impact on the small business communities. We would think that reducing the regulations on a lot of the capital companies that provide capital to small business could do a lot more.

In our industry, we have a bill going through the other side of the hill that would just reduce some of the regulations on our industry so we could invest more. There is the idea that some of the banks could have their regulations loosened.

Mr. HOAGLAND. I am trying to address the sole issue of this $12 billion temporary investment tax credit for companies of over $5 million. Do you view that as a good investment or not?

Mr. GLADSTONE. I do not. The Bumpers bill would be my indication of where I would put the money.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Mr. KOPETSKI. Mr. Brewster may inquire.

Mr. BREWSTER. From my standpoint after hearing what I have recently heard concerning the investment tax credit, at least on large industry, it would appear the money could be used better somewhere else. But on small business, which is my background, it has always been my feeling that the investment tax credit, along with the jobs tax credit, was very effective.

In our State law in Oklahoma, we have an either/or provision. I passed it and happen to like it. Mr. Motley, would you prefer an investment tax credit on small business on a permanent 5 percent basis that was an either/or jobs tax credit or investment tax credit? Would that not be beneficial to small business?

Mr. MOTLEY. That you could take either/or?

Mr. BREWSTER. So many dollars for each job created above the FTEs you had the previous year or so many dollars for investment in new equipment in your industry.

Mr. MOTLEY. From my standpoint, it would be a much more effective proposal because you would not only deal with capital-intensive smaller business, but also with labor-intensive small businesses, which I think are left out of this.

The only thing that most of them see in this, particularly the growing successful ones, are significant tax increases, and we are afraid the reaction is going to be the wrong one.

Mr. BREWSTER. If it could be an either/or of investment tax credit or a jobs tax credit for small industry—your group would support that provision?

Mr. MOTLEY. We would.

On the investment tax credit side, we would probably prefer to go with expensing, which we consider to be easier and a great many small businesses don't have accountants.

The simpler you could make it, the better it would be, but certainly as a second choice a permanent ITC either/or with a jobs tax credit would be effective.

Mr. BREWSTER. We have had that in our State law in Oklahoma since 1985, with pretty good success.

Mr. Donohue, I think all of us tend to think that the trucking industry, fertilizer and others are the losers in this procedure in that you use a disproportionate amount of fuel and it would hit you harder than others.

The 2.5 cents is due to expire. Are you in favor of extending that if we could put it into the highway trust fund?

Mr. DONOHUE. Yes, sir. If we could move it to the Highway Trust Fund to be spent on the full allocation and implementation of the ISTEA which puts it in the national highway system and tends to other matters very significant in States such as yours, we would encourage and would support that move.

I would like to comment, if I might, on the investment tax credit that would give you a number you might have.

Before a small business would pay accountants to get this done, if they bought a $50,000 tractor in 1993 and 1994, they would get $770 back.

I don't know what they would have to pay their accountant. If they bought it after 1994, they would get $550 back. I am not sure that is enough on a $50,000 tractor to change behavior modification.

Mr. BREWSTER. Assuming that we have to raise a certain number of dollars to come up with what we need to work on the deficit reduction and assuming a group of us thought you were paying a disproportionate share, where would you recommend we get the dollars?

Mr. DONOHUE. In the energy tax by leveling the playing field, we give those that are using petroleum and particularly the trucking industry and others a better break than they now have. That doesn't change the numbers at all.

Second, if we looked at this investment tax credit that we are now saying maybe is not as much of behavior modification as we thought, particularly with the large companies—leasing companies can't pass it on—and if we were to eliminate that and take that $12 billion and put that on top of the leveling, we would be getting close to being there and you would have a more balanced playing field.

Mr. BREWSTER. Finally, after a recent opportunity to give a lot of discussion to the VAT and the BTT, it appears we need to have a long-term look toward moving toward one or the other in conjunction with maybe a lower income tax.

Would your industry support that procedure, a VAT or a business transfer tax?

Mr. MOTLEY. Mark probably answered his part of that question five times already.

Every time that we have polled it to the membership, it has come down heavily against it, even when we polled it as a substitute for a current tax. The closest we are to getting any support is to substitute it for FICA.

Mr. BREWSTER. Is it strictly a VAT or a business transfer tax?

Mr. MOTLEY. We polled both and it is still negative. I would imagine that there are several reasons.

One, small business owners tend to feel that they would be the collectors of the tax and it would place more burden on them. Two, it would be hidden. Three, they don't think that the Federal Government needs a lot more money.

Mr. DONOHUE. Small business people have a great nose for things. They operate a lot on instincts and they have a hunch that while a VAT would be a better balance than things we have seen, it certainly would be incremental to what they are now paying. They wouldn't buy much of an argument that you are going to take other taxes away because they haven't seen too many go.

Mr. MOTLEY. I would back that up. I just don't think they would believe that it would be a substitute for something. I could make a lot of arguments why some sort of a consumption tax would be beneficial to smaller businesses, but I don't think they are buying that argument now and there is an educational job needed if they are ever to support something like that.

Mr. CARDIN. Mrs. Johnson.

Mrs. JOHNSON. Thank you.

Mr. Motley, I would like to pursue the line of questioning of Mr. Brewster. On this issue of a job credit versus an ITC versus expensing, it has been my impression that particularly small businesses, because of the simplicity, prefer expensing. It also is more generous. If all you get is $700 for a tractor and you can expense $10,000 in equipment, raising the expensing is a far more powerful reward for investing.

Of those three, would it be best to have an either/or for expensing or job credit for expensing or ITC?

Mr. MOTLEY. If I had to choose, I would pick expensing first because the rule of thumb is the simpler the better. Any time you get into an ITC or jobs credit, we complicate it by all the rules.

The other job credits were incremental in nature. You have to have a base, which makes it difficult for smaller business people who don't hire accountants to deal with it.

My first choice would be expensing. My second choice would probably be, because most small businesses tend to be labor intensive rather than capital intensive, would be a jobs credit. All retailers and service firms and some wholesalers tend to be labor intensive.

The third choice would be ITC.

Mrs. JOHNSON. Your comment about expensing is well taken. You see the same thing in pensions in the last 5 or 6 years. The increase in complexity has been so enormous that it is hard for small business to benefit from many of the things we do. The decline in the number of pension plans in small businesses has been in direct proportion to the increased complexity of our pension laws.

Do any of you want to comment on the issue of expensing with small business, whether it is or is not a powerful incentive, and whether it would make a difference?

Mr. GLADSTONE. I think it is a powerful incentive. I go back to the problem that exists in the marketplace today. The problem is

we have a credit crunch; that is, there isn't capital for small business for growth.

An ITC and jobs credit will go part of the way, but we need a big chunk of capital going into small business in order to grow small business.

Where do you get it—whether it comes out of a consumption tax or a VAT or somewhere along the way, in the end the consumer is paying it.

Remember Congressman Crane's example? When the can of beans gets there, whether you collect it when you pay for the can of beans or all along the way, the consumer in the end paid for the tax in the price of the can of beans. So why not simplify everything and have a consumption-based tax rather than continue to play around with all these intervening ways of doing it?

Mrs. JOHNSON. I appreciate that. I don't think there is any chance of moving in that direction in the next 2 months, however.

I thought your testimony was excellent in that it demonstrated that we could do something about making credit available to the small business community now if we step back from some of the regulations that have made it almost impossible for bank officers to loan, and if we dealt with the litigation issue. I have not heard anyone testify before this committee to that issue and that is very helpful. It demonstrates once again that Congress's absolute refusal to deal with the liability issues in our society, product liability and malpractice liability, has had a very heavy impact on our ability to grow economically and to create the jobs that we need.

We could, if we really cared about it, increase within a month or two the amount of money available to small businesses by changing the regulations and some of the underlying law, the overkill that we passed in the last couple of years in the banking area, and certainly by dealing with the litigation issue. That was a really important point that you made.

I wanted to mention one thing because this has not been brought up at our hearings before and it is of great concern to me. The Clinton package seeks to go after the underground economy by requiring you to complete reports to the IRS in regard to any payments that you have made to anybody over $600.

You mentioned that, Mr. Motley, in your testimony, but I think we need a greater understanding of whether this is going to be a burden and what we are going to get for it in terms of revenue.

Mr. MOTLEY. I can't comment on what we will get from it in terms of revenue. In the last 4 to 5 years, the category of unnecessary Government regulation has moved up 10 slots in our survey of the most important small business problems from the second 10 up to the top 10. Most of that is based upon the unnecessary or the duplicative paperwork that is required by the Federal Government whenever a new law or regulation is passed.

It is a very heavily indirect and almost invisible tax which we place day in and day out on small business owners around this country. Many of them have to hire somebody just to fill in the paperwork. We consider this particular proposal to be a significant expansion of that burden.

Mr. BLOOMFIELD. May I comment on your question about which way to go: expensing or the investment tax credit?

My first point would be a comment on the administration's small business investment tax credit which is limited to businesses that have sales of $5 million or less. Those companies account for only 13 percent of investment in plant and equipment in the United States. Alternatively, if you look at the manufacturing sector, those companies account for about 3 percent of investment in plant and equipment.

I do not mean to be critical of small business which, as was pointed out, is a vital engine of job creation in this country. But if the objective of the plan is to do something about investment in this country, the administration's investment credit proposal does not do the trick.

Second, look back to John F. Kennedy's investment tax credit proposal, which is a far cry from what you have in this package. The John F. Kennedy investment tax credit was good because it was supposed to be permanent, nonincremental, and broad based. Yes, I understand the old John F. Kennedy investment tax credit applied to barber chairs and carousels, and that is a problem, but it had some real economic punch to it.

Third, we did not have an AMT at that time. Therefore, I would suggest that a good John F. Kennedy investment tax credit should be credible against the AMT and it should be sizable.

Why do I say that? I say that because a credit is much more beneficial to a taxpayer than a deduction. That is not to say that expensing doesn't get you the same result.

Remember, I said that the Stanford Professor Shoven's work pointed out that over a period of time several provisions had about the same effect. In the short term, however, a credit is much better than expensing.

I would agree with you that you have a bill that is going through now and you have to worry about the short term, which is how you try to make the President's proposal more procapital formation.

The problem is a long-term problem of many years of deficit financing which has to come to an end. How do you finance a procapital formation tax package? You cannot finance it within the budget constraints that you are under.

For example, the John F. Kennedy investment tax credit, which I think did a lot of good, costs about $30 billion a year. I agree that you have to focus on the short term, but you are constrained because our current income tax system politically and economically cannot sustain the demands put on it. That is why I advocate enacting a U.S. consumption tax.

Mr. CARDIN. Mr. McCrery will inquire.

Mr. MCCRERY. Some of us on the Republican side, believe it or not, are looking for kind of a middle ground on this debate on the budget. We admit that it would be desirable to have increased revenues to reduce the deficit, but probably only about half the extent to which the President has proposed, maybe a little less than half in terms of the total revenues to be raised, and then we would cut spending more to achieve more deficit reduction.

I want to ask you gentlemen, if we were to drop the Btu tax out of the package, drop out of the package the corporate rate increase, leave in the package a personal rate increase to 36 percent pegged at $200,000 of taxable income plus a surtax on incomes of $250,000

and above, and increase expensing from $10,000 to $25,000, how would that affect small businesses?

How would it affect capital formation for small businesses, subchapter S corporations versus subchapter C corporations? I know I am hitting you with this all at once, but can you give me some general thoughts on how that revenue package would affect small businesses and capital formation?

Mr. DONOHUE. Sir, I think if you quickly added up the things that you were talking about, maybe you are getting up at $75 billion to $100 billion, I am not sure. The first thing I would say to you is that $100 billion that will be left in the private sector for development, for investment, for expenditure, for consumption otherwise will go into the Government sector.

That is a very simple transfer of funds from one sector that tries to put them to productive use to the other sector who wants to use them to eliminate its deficit. I think that you can come to a series of conclusions of how we would benefit.

There will be more money to lend, invest and spend and I think you would be moving in a very positive direction. I agree this is going to be a middle ground type of arrangement.

I think you have here four people that recognize that. We have done this before. We have sensed the sentiment in this committee and in the Congress.

We hope that that middle ground is going to be one that is balanced, one that looks at who has to pay the taxes, and how do we keep the vitality of these small companies alive.

Mrs. Johnson raised a question about these reports on payments of over $600. That is environmentally unsound.

Do you know how many trees we are going to have to kill to make the paper to make those reports? This is a significant interruption of progress. I think that you are on the right track.

I don't know how many people you can get to associate yourself with that sort of type of common sense at this time, but I wish you well.

Mr. GLADSTONE. Let me make one comment. For 4 years now, we have seen the number of small businesses decline. Is there any wonder that job creation is down? If you have the engine that creates jobs, which is small business, creating 80 percent of the jobs, and each year the decline in new small business formation goes down, down, down, is there any wonder that we don't have job creation?

If you want job creation through small businesses, you have to stimulate them. An ITC is not going to do it. A jobs creation bill is not going to do it. They need capital. Capital comes from two sources: one, bank loans currently in disarray; and the second from wealthy individuals, not the super rich who make billions of dollars each year, but the men and women that make $200,000 to $1 million a year. Those are the people who put up $20,000 to $50,000 to start a business.

If you are taxing those people, that money is going directly out of their pockets which may have ended up in small businesses, and small business creation into the deficit reduction. I think it is a disaster to put a surtax on that group of individuals, not because I am in favor of them so much, but because I know of the job cre-

ation and the wealth formation in the small business sector that will go on because of them.

Mr. MOTLEY. Two points.

First, if you really start looking at small business creation start-ups, I think you have to start looking at payroll taxes. There is a tremendous impact in the early years of a business by payroll taxes because they don't relate to profitability of the firm. You can put together a package of changes that would encourage business start-ups in this country.

Second, any time you start moving toward spending cuts to reduce the deficit and less toward tax increases that perks our interest and would be much more supportable.

There is a point I think where most small business people would say yes, we have to contribute to this. This package isn't anywhere near it right now, but moving in the direction you are suggesting would certainly get a longer, harder look.

Mr. MCCRERY. A specific point. Raising the personal rate for upper-income taxpayers to 36 percent and leaving the corporate rate where it is—what does that do, if anything, to small business?

Mr. MOTLEY. You kick your taxable income, I think, up to $200,000. That obviously is going to excuse a great many more small businesses. I can't give you exactly——

Mr. MCCRERY. You don't see a great exodus from subchapter S corporations into C as a result of that differential——

Mr. MOTLEY. We need to take a closer look at that and get back to you. We did have an exodus from C corporations to subchapter S after 1986. I don't know what we have to do to start the movement back the other way.

Mr. CARDIN [presiding]. If the gentleman would yield on that point, I would welcome that information. We have had a couple of business people in our district who have told us that they are very likely to return to a C corporation with the differential.

Mr. MOTLEY. They are probably getting advice from my accountants, one that you know since you are my Congressman, because he has been saying that for about a month. That is what he is going to advise everybody to do.

Mr. CARDIN. Mr. Hancock.

Mr. HANCOCK. Thank you very much.

I suppose it isn't too good an idea for a new member of Ways and Means to be critical of the committee, but it is kind of interesting to me that we had practically every member of this committee here to listen to Mr. Reischauer from the Congressional Budget Office, and yet we are talking to a group here that is interested in creating jobs and there are only two of us left. Maybe that sends a signal where we have our priorities; I don't know.

I am absolutely convinced that the way to reduce the deficit is to do whatever we can to generate economic activity in the private sector. That is the only true growth. I am still convinced that the so-called trickle-down economics would have worked if Congress had stayed out of it. But when we saw it being successful, we couldn't stand it, so we had to do something about it.

Confusion exists right now in the business community about what Congress is going to do, especially in the small business community, for the guy thinking about starting a new business or the

one thinking about expansion. In your judgment, what impact is that confusion having now? If we could get this thing settled so that the small businessman knew the ground rules and knew what to deal with, what do you think would happen to the economy right now?

Mr. MOTLEY. I think there is no doubt that most small business people are sitting on their hands. They are flexible enough to wait. That is one of the strengths that they have in the competitive marketplace is flexibility, and they are not going to do anything until they have some clear indication of what is going to happen here in Washington.

I think once the decisions are made, our economic data shows that they are poised to take advantage of a recovering economy.

Mr. HANCOCK. I am a small businessman and I naturally associate with a lot of small business people and I associate with their employees as well. The story I am getting back home is "Look, make up your mind. Tell me where you all are going. Am I going to get investment tax credit?"

I had a gentleman that owns a McDonalds call the other day. He said, "I am ready to spend $100,000 expanding our facility, but," he said, "I would hate to go ahead and do it now and then have them pass the investment tax credit." So he put it on hold.

In my little company, my son is ready to hire two people. He needs them now, but he doesn't know whether we are going to be able to afford to do it because of the potential of substantial tax increases on the owners of subchapter S corporations. If, in fact, we go to the rate that we are talking about, that is two jobs that won't be created this year. We will just make do.

You mentioned this credit crunch, the capital crunch. You are exactly right, Mr. Gladstone, that the money that starts small businesses comes from people that have been moderately successful in a business and they have their income up and they are willing, maybe, to help somebody get started, perhaps some employee that wants to go into business for himself.

I have known an awful lot of that to occur. In fact, I can think of one just recently where this guy had a chain of franchises and he had a manager. He had heard about another franchise location so he said "I will help you get started." So the manager left and opened up another franchise.

This is what makes the whole system work. I just wonder frankly how many people here in Washington understand that. I have been trying to preach that sermon and I haven't been able, I don't think, to be too successful.

Mr. GLADSTONE. In the investment community, they are known as angels. I would suggest if we are beginning to tax the angels and take their money away, we are not going to have too many more small businesses because that is where the bulk of the capital comes from.

Mr. HANCOCK. When I have been involved in helping get a small business started, the issue has been, can you get 10 people to put up $10,000? That is where most capital comes from in the truly small business. That is why I am extremely concerned about what we are talking about.

I don't think it is going to create jobs. Government can only create temporary jobs, and somebody has to pay for those.

Mr. MOTLEY. We did a study 3 or 4 years ago called "New Business in America," and it tracked a number of firms for the first 3 years of their life cycle.

The first place that capital for starting new businesses comes from is personal savings and wealth. The second place is from relatives who have personal savings and wealth, and the third place is from banks.

So in order to encourage that type of investment, to get your relatives and friends together to start a small business is extremely important and it means a great deal because a lot of these new jobs come from the birth cycle of small firms. Most small businesses hire their full complement of workers within their first 18 months of existence. So if we stop the small business creation cycle, then we are going to have a problem in the job creation cycle in the United States.

Mr. CARDIN. Let me thank the panel.

As Mr. Hancock knows, we had a significantly larger number of people here during part of your panel's presentation. I think it is important to note that one of the first groups of private sector people that were invited to testify on the economic package included small business interests because of the importance to our economy of the people that are represented by the panel that just completed their presentation.

So I want to thank each of you for your presentations today and for participating in our hearings.

The next panel will consist of Peterson Zah of the Navajo Nation; David Keating, National Taxpayers Union; James Santini, National Tour Association; and the National Committee to Preserve Social Security, Martha McSteen.

Welcome to the Ways and Means Committee. Your full statements, without objection, will be made part of the committee record.

We will start with Peterson Zah.

STATEMENT OF PETERSON ZAH, PRESIDENT, NAVAJO NATION

Mr. ZAH. Thank you for giving me the opportunity to represent the Navajo Nation and other Indian tribes across the country to suggest to the committee that last year in H.R. 11 there was a provision for an Indian employment credit and investment tax credit and it should be included in this year's legislation.

We have a situation throughout America on most Indian lands where the unemployment rate for Indian country averages 56 percent. That is almost unheard of anywhere throughout America, when you look at all of the poverty-stricken areas.

One of the things that we as Indian people need is to have another tool that we can work with so that we can convince private business people to come and relocate to the Indian nations, to the Indian reservations.

We have many things to offer those companies, but we believe that if we can have employment and investment tax credits, we would be in a better position to compete with the other urban areas in trying to entice those businesses to come to our reservation.

We certainly would appreciate the inclusion of the Indian provision that was passed by Congress last year. H.R. 11 subsequently was vetoed by the President at the time. We also want the committee to know that the Senate Select Committee on Indian Affairs has reintroduced that bill with very, very strong bipartisan support from Members of the Senate who have large Indian populations in their home State areas.

We are here to persuade you to include some of those provisions so that we can take care of the most economically depressed areas in the United States—Indian reservations.

I also want to emphasize that for many, many years we have been wanting to have Indian tax credits be established by Congress, but instead in some legislation there has been enterprise zones that were proposed. I think the present administration may also be essentially doing the same thing.

We appreciate this as Indian people, except we need a little more than that, because enterprise zones are only going to take care of a certain number of Indian tribes. If you go to a business and try to persuade them to come to an Indian reservation, Indian land, we don't have all the basic infrastructure, the highways and the schools and the availability of water and all of these other basic things that they would need, so, we can't very well compete with those other areas. That is why enterprise zones will not work.

By having those Indian country tax credits, we feel that that can do the job of convincing many of those businesses to come to our lands in order to restore Indian employment and through that a lot of things could happen.

As you know, there are a lot of problems out there on Indian reservations and employment is one of those areas where if we can take care of the employment needs of our people, it does a lot of things, such as keeping them off the welfare roll.

We have an alcoholism problem. We have high suicide rates on Indian reservations. We believe that if we can do these kinds of things through Government action, we can persuade some of those businesses to help us and give us the helping hand that we need. We are not necessarily asking for a handout.

Thank you very much.

Mr. CARDIN. Thank you.

[Mr. Zah's prepared statement and a letter from Representative Richardson follow:]

NAVAJO NATION WASHINGTON OFFICE

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Committee on Ways and Means
United States House of Representatives

Hearings on President Clinton's Proposals for
Public Investment and Deficit Reduction

TESTIMONY OF PETERSON ZAH,
PRESIDENT OF THE NAVAJO NATION,
ON

INDIAN EMPLOYMENT AND INVESTMENT TAX CREDITS
TO ADDRESS INDIAN COUNTRY UNEMPLOYMENT
AND INFRASTRUCTURE DEFICIENCIES

My name is Peterson Zah. I am the elected President of the Navajo Nation, the country's largest Indian tribe. Spanning the states of Arizona, New Mexico and Utah, the Navajo Nation has a total land area equivalent in size to the State of West Virginia, and encompasses almost one-third of all American Indian lands in the Lower-48 states.

I thank you, Mr. Chairman, and Members of the Committee, for this opportunity to testify at these important hearings. I speak today in strong support of the "Indian Employment and Investment" tax credits that the 102d Congress enacted last October as Sections 1131 and 1132 of H.R. 11, the "Revenue Act of 1992." But for President Bush's veto of that legislation on the day following the general election, those Indian country employment and investment tax credits could, as we speak, be helping tribal leaders in 32 states address what I described last year as "the deplorable conditions existing in Indian country -- conditions which truly are a national disgrace."

The Indian country tax credits which Congress passed in H.R. 11 have now been re-introduced in the House and the Senate as H.R. 1325 and S. 211, respectively. Accordingly, the purposes of my testimony today are threefold. First, to make you aware of Indian country conditions that cry out for the type of innovative, private sector-oriented economic development tools that these tax credits represent. Second, to explain why these Indian country tax credits are far superior to enterprise zones -- one of the Administration's proposals for this year -- because they can potentially benefit all of Indian country rather than the very few reservations that might be selected for zones. Finally, I will attempt today, with all the persuasive powers at my disposal, to convince you of the urgent need for, and the singular importance of, adoption of these Indian country tax credits in your 1993 tax legislation.

CONDITIONS IN INDIAN COUNTRY

Indian Unemployment and Poverty -- **56%**. For American Indians, 56% is a tragic number, because it constitutes the average Indian unemployment rate on reservations throughout the United States. As Chairman Daniel K. Inouye of the Senate Select Committee on Indian Affairs reported during that Committee's 1989 hearings on Indian economic development:

> **The unemployment rate on the majority of Indian reservations is simply incomprehensible** to the average American. During the height of the so-called Great Depression in the 1930's, unemployment averaged 25 to 30%. **In 1989 the average rate in Indian country is 52%!**

In 1993, that rate is 56%.

The conditions of poverty that persist throughout Indian country are unspeakable. Despite our reputation as one of the tribes which is "better off," 56% -- coincidentally -- of Navajo people live below the poverty level. It is not unusual for households at reservations across the country to lack telephone service, or electricity, or running water, or all of the above. The result is that here, within the borders of the United States of America, most reservations have living conditions which are far worse than exist in many of the Third World countries to which the federal government provides substantial foreign aid.

Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in infrastructure and job opportunities than Indian reservations.

Disincentives to Private Sector Investment in Indian Country -- If the Members of the Committee could travel reservation-by-reservation -- across 32 states -- you would well understand the economic deprivation that tribal leaders and Indian people confront each and every day. We work very hard to attract new private sector jobs and investment to our reservations. The Navajo Nation, for example, offers the advantages of a large workforce, rich natural resources, an ideal location, and a well-trained, sophisticated three-branch government. However, tribal leaders' efforts are continuously undercut by a variety of obstacles -- endemic to investing on reservations -- that have prevented Indian country economies from securing their fair share of the business and jobs in this country.

First and foremost are massive infrastructure deficiencies. For example, the Navajo reservation has 2,000 miles of paved roads, while West Virginia is the same size and has 18,000 miles. Many of the dirt roads on which our people heavily depend are simply impassible when the weather is bad. As noted above, even something so basic as telephone service is lacking in Indian country; over half of all reservation Indian households lack basic telephone service.

Another significant disincentive to economic development -- which I hope the Committee will address in the future -- is the growing problem of "double taxation," wherein states increasingly are assessing taxes on non-Indian business activities permitted by, and occurring wholly on, Indian lands. As I explained in July of 1991 to this Committee's Subcommittee on Select Revenue Measures:

> This double taxation interferes with our ability to encourage economic activity and to develop effective revenue generating tax programs.
>
> * * *
>
> We find it especially hard to attract business to the reservation unless we make concessions that nearly defeat the purpose of wanting to attract business to the reservation in the first place.

These infrastructure deficiencies, double taxation and related problems lead to the same result nationwide -- Indians do not compete on a level playing field with even the most economically distressed non-Indian areas. As a result, Indian country is typically left behind, or left out altogether, from economic development opportunities. To help level that playing field, and to provide tribal governments and Indian country business planners with additional tools to compete, the Navajo Nation believes that new approaches -- tied to the tax code, and geared to the private sector -- must be tried.

INDIAN EMPLOYMENT AND INVESTMENT TAX CREDITS

I will not review in detail the specifics of the "Indian Employment and Investment" tax credits. They were adopted by the Congress less than six months ago. The legislative language is set forth at pages 45 - 53 of the "Conference Report to Accompany H.R. 11" (H.R. Report No. 102 - 1034, issued October 5, 1992); the Conference Committee's detailed explanation of those Indian country tax credits can be found at pages 715 - 718 and 721 - 725 of the Report.

In summary, the **Employment Credit** provides for a 10% credit to the employer based on the qualified wages and qualified health insurance costs paid to an Indian. As an added incentive, a significantly higher employment credit of 30% is offered to reservation employers having an Indian workforce of at least 85%. The credit, which is limited to "new hires" and to those employees who do not receive wages in excess of $30,000, focuses on job creation and would be allowed only for the first seven years of an Indian's employment.

The **Investment Tax Credit** is geared specifically to **reservations where Indian unemployment levels exceed the national average by at least 300%**. The legislation provided 10% for personal property, 15% for new construction property and 15% for infrastructure investment on or near reservations. (If a nationwide investment tax credit and/or employment credit were to be adopted in 1993, the Indian reservation tax credit percentages would likely need to be adjusted upward to maintain the so-called "Indian differential," which is absolutely essential in order to help mitigate the unique problems -- particularly the lack of infrastructure -- that act as disincentives to Indian country investment.) One-half of the specified credit percentages would be available for qualifying investments on reservations where unemployment exceeds 150% but does not exceed 300% of the national average.

In response to concerns raised by several Members during Senate consideration of these measures in 1992, "anti-gaming" restrictions were incorporated in H.R. 11. These prevent both the investment and employment credits from being used with respect to the development and/or operation of gaming establishments on Indian reservations.

Most importantly, these incentives would potentially benefit all of Indian country. This is the critical difference between these Indian country tax credits and alternative approaches that would provide only for a limited number of Indian enterprise zones.

Now, I am not opposed to the concept of enterprise zones; in fact, I testified in favor of such zones several years ago. However, that approach is woefully inadequate for Indian country. **A limited Indian enterprise zone proposal could possibly help a very few tribes, but would dash the hopes of the many other reservations around the country which were not selected as zones, and whose people would not benefit at all.** Thus, for all of those reservations not selected, an Indian enterprise zone approach would leave unabated the pervasive poverty and high unemployment that have perpetually defined life on those reservations.

Moreover, even those reservations that might be selected as zones under a limited Indian enterprise zone approach would be unlikely to benefit. As previously noted, due to the lack of infrastructure, "double taxation" by the states and related problems, **Indian reservations simply cannot compete with even the most economically-distressed inner cities and other non-Indian communities**. In other words, given the choice, new business would in almost all instances opt to locate in non-Indian areas to avoid the unique difficulties that are inherent in locating on reservations. Accordingly, Indian enterprise zones offering the identical incentives as non-Indian rural zones would remain unable to compete on anything close to a level playing field.

It is this set of unique Indian country circumstances -- highlighted by the unconscionable 56% average Indian unemployment rate -- that can and do justify a separate program for American Indians, such as that included in H.R. 11 (i.e., adopting the Indian country tax credits in lieu of then-pending proposals to establish a limited number of Indian enterprise zones). Adopting a separate, reservation-based program for American Indians is consistent with the distinctive legal and political status of Indian tribes and their government-to-government relationship with the Federal government, and has been upheld by the Supreme Court (Morton v. Mancari, 417 U.S. 535 (1974)).

INDIAN COUNTRY TAX CREDITS ARE URGENTLY NEEDED

For almost a decade, Chairman Daniel Inouye, Co-Chairman John McCain and other Members of the Senate's Select Committee on Indian Affairs had sought to amend the tax code to provide incentives for new private sector investment in Indian country. However, little progress was made during that period. As Chairman Inouye noted last year, in comments applauding Congressional adoption of these tax credits in H.R. 11, "it has been a difficult, and I must admit, an often lonely battle to compete with numerous other interests seeking changes to the tax code before the Finance Committee" and, I might add, the Ways and Means Committee.

In 1992, I designated federal tax incentives as one of my Administration's highest legislative priorities. Drawing from bills previously introduced by Chairman Inouye, Co-Chairman McCain and other Senate Select Committee Members, the Navajo Nation developed the initial legislative language for these employment and investment tax credit proposals. Thereafter, under the bipartisan leadership of Chairman Inouye, Co-Chairman McCain and Senator Domenici of the Select Committee, with the interest and attention of Senators Baucus and Boren of the Finance Committee, and ultimately with the support of then-Chairman Bentsen and Ranking Member Packwood of the Finance Committee, the Senate adopted the Indian country tax credits in lieu of the then-pending Finance Committee bill that would have created enterprise zones on just ten reservations.

In so doing, the Senate wisely opted for a legislative response that fit the problem, recognizing that the nationwide Indian unemployment problem warranted a nationwide program to address it. Subsequently, the Senate-passed provisions were accepted by the House in Conference, and enacted in the vetoed H.R. 11.

Indian Country Tax Credits Are Consistent With Clinton Administration Goals -- Having come so far in 1992, Indian country felt reasonably confident that the new Administration would take the lead in promoting these measures to help address the staggering Indian unemployment levels and the massive reservation infrastructure deficiencies that exist -- uniformly -- in Indian country. When I participated in President Clinton's pre-Inauguration "Economic Summit" in Little Rock, I reviewed the urgent need for Indian economic development; explained that new investment and jobs in Indian country would also spill over to provide economic benefits to adjoining non-Indian communities; and stressed that American Indians are not looking for hand-outs, but only a helping hand. Frankly, the Administration's failure to date to include these Indian country tax credits in its proposals -- and to focus, instead, on a limited number of Indian enterprise zones (reportedly five) -- has been a disappointment.

In "putting people first," the federal government could well benefit from giving priority attention in this year's tax bill to those citizens whom our nation historically has neglected until last -- American Indians. These Indian country tax credits offer hope throughout all of Indian country that new private sector investment, jobs, and infrastructure development may at last become a reality in some of the most destitute areas of the United States. As a result, the Indian reservation investment and employment tax credits enjoy the support of Indian tribes across the nation and, in fact, can help to attract economic development to reservations in:

Alabama	Maine	North Dakota
Alaska	Massachusetts	Oklahoma
Arizona	Michigan	Oregon
California	Minnesota	Rhode Island
Colorado	Mississippi	South Dakota
Connecticut	Montana	Texas
Florida	Nebraska	Utah
Idaho	Nevada	Washington
Iowa	New Mexico	Wisconsin
Kansas	New York	Wyoming
Louisiana	North Carolina	

Mr. Chairman, these Indian country tax credits respond to a demonstrated need requiring urgent action. They offer an easy-to-understand, simple-to-administer, private sector-oriented approach to Indian economic development without creating a new layer of governmental bureaucracy. They only cost the federal government if they work; even then, estimated costs are comparatively modest ($181 million over a five-year period according to Joint Tax Committee estimates last year).

Significantly, the Indian employment and investment tax credits have a proven legislative track record and continuing bipartisan support in the Congress.

CONCLUSION

American Indians cannot continue -- for yet another generation -- to compel our young people to leave their homes and their families because meaningful employment opportunities are lacking in Indian country. Today, these "Indian Employment and Investment" tax credits remain as urgently needed as ever before.

In January, Chairman Inouye and Co-Chairman McCain re-introduced, as S. 211, the identical Indian country tax credits that Congress adopted in H.R. 11. Just last week, Chairman Bill Richardson of the Subcommittee on Native American Affairs of the Natural Resources Committee introduced, as H.R. 1325, a companion bill in the House. On March 10, twelve Members of the Senate -- from both parties -- wrote to Secretary Bentsen to urge that the Administration include these provisions in its final tax package to be submitted to the Congress.

Mr. Chairman and Members of the Committee, the stage is set. This Committee can, in 1993, exercise the leadership to help Indian country achieve this long-sought legislative goal that, after years of frustration, we came so close to realizing in 1992.

In closing, I would simply like to quote from the written statement that I submitted to the Committee a little over a year ago in support of these incentives:

> Helping American Indians to help themselves is neither a Democratic issue nor a Republican issue; it's not a conservative policy or a liberal policy; it's not even a "special interest" issue. Rather, it is a "human" issue that must, and deserves to be, addressed from a **national perspective on a bipartisan basis**, and with a real sense of urgency warranted by the deplorable conditions existing in Indian country -- conditions which truly are a national disgrace.

I sincerely appreciate this opportunity to testify, and I respectfully urge that the Committee include in the tax legislation that it will report in 1993 the modest -- but extremely important -- Indian country tax credits that the Congress in fact adopted just six months ago.

March 16, 1993

* * *

[ATTACHMENTS TO THIS STATEMENT ARE BEING RETAINED IN THE COMMITTEE FILES.]

MEMORANDUM

TO: Staff of the Committee on Ways and Means

FROM: Representative Bill Richardson
Chairman, Subcommittee on Native American Affairs

DATE: April 28, 1993

SUBJECT: April 27, 1993 Letter to Chairman Rostenkowski

I am sending this letter in support of H.R. 1325 and in support of testimony from the Navajo Nation to your Committee on April 1, 1993. I respectfully request that it be included in the hearing record with the Navajo statement. I am sending the original to the Chairman's personal office.

Attachment

U.S. House of Representatives
Committee on Natural Resources
Washington, DC 20515-6201

April 27, 1993

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515-6348

Dear Chairman Rostenkowski:

I am writing on a single issue that is of urgent importance and that falls squarely within your Committee's jurisdiction -- the **Indian Employment and Investment Tax Credits** which Congress passed just a few months ago as Sections 1131 and 1132 of the vetoed "Revenue Act of 1992" (H.R. 11). I have re-introduced those identical provisions in H.R. 1325, the "Indian Employment and Investment Act of 1993". I urge your Committee to exercise the leadership that will put this Committee and the House in the forefront on this issue and that will lead to re-adoption of the very provisions that we passed last October.

There can be little doubt about the urgency of enacting these employment credits and investment tax credits to help Indian tribes in their efforts to build infrastructure, provide jobs, and offer hope to their people. The entire country has been suffering during these hard economic times, and the new Congress and the new Administration are working together in a new spirit of cooperation to pull this country back to the prosperity that all Americans deserve. However, unspeakable living conditions in Indian country set Indian reservations apart from the hardest-hit inner cities and rural areas -- and demand special attention and the meaningful, new private sector-oriented incentives that the Indian country tax credits will provide.

Nowhere in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country. **Unemployment on Indian reservations nationwide averages 56%**. Poverty rates are alarming, and debilitating to Indian children and Indian families. Infrastructure that most Americans take for granted is often non-existent on Indian reservations. In the Navajo Nation, for example, there are 2,000 miles of paved roads; West Virginia, which is the same size, has over 18,500 miles. Running water, electricity and other necessities of life are often unavailable on Indian lands.

According to the 1990 Census, of the 1.8 million American Indians, Eskimos and Aleuts in the United States, one-third live below the poverty level. According to a 1992 report by the University of Minnesota, the teen suicide rate among American Indians is four times that of other ethnic groups. Recently, the Indian Health Service reported that tuberculosis rates among Indian people exceeded all other ethnic groups by 400%. The BIA estimates that 93,000 Indian people live in substandard housing or are homeless.

It would be easy to simply assume that Indian country might benefit from the nationwide tax incentives the Administration will propose, and to leave it at that -- but we would be wrong. Neither the same business investment tax credit nor an extended/expanded targeted jobs tax credit would provide sufficient added incentives to overcome the infrastructure deficiencies that pose a substantial barrier to investment in Indian country. Moreover, neither of those incentives will help to attract -- as would the Indian country tax credits -- larger, labor-intensive industrial investment that is most likely to entail new facilities to existing large business enterprises. Finally, neither of those incentives, if available elsewhere in the United States, will provide the added inducement necessary to help level the playing field so that Indian country can begin to compete against other areas.

Moreover, it is unrealistic to believe that enterprise zones at Indian reservations will be able to compete against non-Indian zones offering the same tax incentives and benefits. Again, the higher infrastructure costs would in virtually all instances cause potential investors and employers to choose the zones at non-Indian areas which already have the roads, telephones, etc. that are lacking in Indian country. Thus, enterprise zones -- even for the few reservations that are selected -- will do nothing to level the playing field that currently prevents Indian country from competing effectively against even the most distressed non-Indian areas.

In H.R. 11, Congress recognized that the unique circumstances of Indian country required unique treatment. Under your leadership, Mr. Chairman, the conference accepted those Indian provisions and the Congress subsequently adopted them. Having sought tax incentives of this type for some ten years, Indian country thought that private sector economies on reservations would finally become a reality, but the celebration was short-lived, as President Bush vetoed the legislation on the day following the election.

In the 103rd Congress we should finish the job, and we should do it in the 1993 tax bill. Now, some may question the advisability of establishing a separate tax incentives program for Indian country, but they would be wrong. Our laws allow for it; reasoned legislation requires it; and sound public policy and our moral responsibilities demand it.

First, Indian tribes have a unique legal and political status in our country, and their relationship with the Federal government is on a government-to-government basis. This

status is well-recognized in treaties, trust obligations, statutes and case law. Adopting a separate, reservation-based program is consistent with this unique status, and has been upheld by the Supreme Court.

Second, as previously noted, reasoned legislating -- and common sense-- requires that we legislate a response that fits the problem. A limited Indian country enterprise zone proposal does not go far enough. Participation in a nationwide incentive (e.g., a small business investment tax credit) offering the same level of benefits within Indian country as in non-Indian areas does not offer the needed "Indian differential" to help overcome infrastructure deficiencies and related Indian country economic development barriers not shared by other areas.

Third, the staggering unemployment and poverty rates on Indian reservations demand that we take innovative new approaches to address them.

The adoption of the Indian Employment and Investment Tax Credits should be among the "easier" decisions to be made in the 1993 tax legislation. The need is demonstrated, and unquestioned. The tax credits are relatively modest in cost, with last year's Joint Committee on Taxation providing a revenue estimate of $181 million over a five-year period. The credits do not funnel funds into creating -- and perpetuating -- a new governmental bureaucracy, but instead are available directly to the private sector. They focus on creating new jobs where they are most needed. (For example, the full reservation investment tax credit is available only at reservations exceeding the national average unemployment rate by at least 300%.) They promote infrastructure investment where it is sorely needed. The tax credits are understandable to investors and employers, and easy to administer. They offer potential benefits for all of Indian country, rather than to a very few reservations. They are supported by the Navajo Nation, the National Congress of American Indians and its members throughout the United States, and many other Indian tribes.

And, **we have already passed these provisions**, which have continuing bipartisan support. Let us pick up where we left off last fall. I ask the Committee -- and the House -- to provide the leadership that will at last incorporate these urgently-needed tax incentives into our nation's tax code and tax policies.

Thank you for your kind consideration of this important matter.

Sincerely,

BILL RICHARDSON
Chairman
Subcommittee on Native American Affairs

Mr. CARDIN. Mr. Keating.

STATEMENT OF DAVID KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION

Mr. KEATING. Mr. Chairman and members of the committee, thank you for the opportunity to express our views on the tax proposals and the administration's package.

I appear on behalf of the 200,000 members of the National Taxpayers Union. We are greatly disappointed that the President's tax package breaks a key campaign promise to middle-class taxpayers. We believe the package would destroy hundreds of thousands of jobs and it would reverse some of the most positive aspects of the 1986 Tax Reform Act while introducing new and unnecessary complexity into the Tax Code.

Our greatest disappointment, however, is that the President's budget has failed to tackle the structural deficit caused by out of control spending.

The tax hikes in this package will fall far short of reducing the long-term deficit, and unless spending is controlled, massive tax hikes on middle-class taxpayers are just around the corner. There simply are not enough rich people around to pay for all the government the current laws promise. That is why spending must be tackled now.

For the first time in this century, the top tax rate in America, if this package is adopted, will be higher than in England. Remember, the English economy through much of this century stagnated while America prospered largely because ruinous tax rates drove entrepreneurship and business in Britain into the ground.

The same policy that helped ruin England as an economic power is now being proposed for this country, including the idea of a class war to turn tax spenders against taxpayers.

It is ironic that just 7 years ago, this country led an international revolution toward lower tax rates on work efforts. We are now moving in a reactionary fashion that will greatly harm our economy.

We also fear that these higher tax rates on upper-income taxpayers are really a first step in soaking the middle class. We seriously doubt that the average American supports these new confiscatory tax rates that approach 50 percent.

A poll conducted for the National Taxpayers Union Foundation last year found that 70 percent of Americans agreed with the following statement: the highest Federal income tax rate on any part of a taxpayer's income should not be higher than 25 percent.

We agree with the statements made on the previous panel that these higher tax rates will harm incentives to work and invest, and we agree in particular with those comments by Professor Feldstein.

I will turn my comments to items that I have not heard yet this morning.

One, President Clinton says he supports high-skilled, high-wage jobs. Yet, one perverse effect of his proposal is to tax families where both spouses have high-skill, high-wage jobs.

The marriage penalty would steeply increase for married couples earning roughly the same income if that income is over $70,000 in taxable income per year.

We are equally disturbed about the marriage penalty created by a more generous earned income tax credit. While we support many of the goals of the EITC, it is beginning to have serious and unappreciated side effects.

One is that the phaseout of the earned income tax credit is creating apparent marginal tax rates that often approach 40 percent for some of the working poor in this country. If we have a higher EITC, depending on the details of the proposal, we might create more disincentives to work among the working poor and lower middle-income taxpayers. Potentially millions more taxpayers may see these effective marginal tax rates approaching 40 percent.

Also disturbing is the marriage penalty from a more generous EITC. There is already a tax incentive for the working poor not to marry or stay married and such incentive could greatly worsen under an expanded EITC if it is not well designed.

I would also like to briefly say something about the proposed energy tax. The worst feature of this tax lies in its potential to kill jobs. One of America's competitive advantages in the international arena is our energy costs. By taxing energy, we are putting our exporters at a severe competitive disadvantage worldwide and that will result in lost sales or lower profits and more importantly, lower wages and fewer jobs.

I would also like to say a few things about the Social Security tax changes in the package. While we are sympathetic with the goal of targeting Social Security benefit payments to the elderly poor, this tax scheme is flawed.

The 85-percent figure in the proposal will strike many Social Security recipients as being arbitrary and it is. We believe it could be improved by taxing only the excess of benefits received over taxes paid during a recipient's lifetime.

This would have other side benefits as well. It would dramatically increase public understanding of the Social Security system. Many elderly believe the myth created by years of government propaganda that they only receive benefits that represent a return of their Social Security taxes.

By giving each recipient a statement each year showing total taxes paid and total benefits received, that would increase the understanding of how the system works.

Finally, I would like to comment on the investment incentives in the proposal. Overall, we think they are very weak and don't come anywhere near offsetting the damage caused by higher marginal tax rates and the new energy tax.

We would also like to suggest that if the capital gains reduction provision is kept by this committee, that it be improved by allowing people to roll over investment profits even if the stock is sold within the 5-year period as long as it is reinvested in a similar original issue stock from a qualified corporation.

There is no reason for a 5-year holding period as long as the stock profits are rolled into a new qualified investment. Overall, we believe the proposals, if adopted as is, will greatly harm economic growth and destroy jobs. We would urge the committee to make rather drastic revisions.

Thank you very much.

[The prepared statement follows:]

Statement of

David Keating
Executive Vice President
National Taxpayers Union

on

President Clinton's Proposals
for
Public Investment and Deficit Reduction

before the

Committee on Ways and Means
U.S. House of Representatives

March 16, 1993

Mr. Chairman and Members of the Committee, thank you for the opportunity to express our views on President Clinton's tax proposals. I appear on behalf of the 200,000 members of the National Taxpayers Union.

The President's tax package breaks a key campaign promise to middle-class taxpayers, and would destroy hundreds of thousands of jobs. It reverses some of the most positive aspects of the 1986 Tax Reform Act while introducing new and unnecessary complexity into the tax code. Our greatest disappointment is that the President's budget plan guarantees higher taxes, but fails to control spending.

The tax plan is a hodge-podge of tax increases. If enacted, the plan would be one of the largest tax hikes in history—and is comprised of dozens of tax increases, many of which the Administration calls spending cuts.

The chief failing of the deficit reduction plan is that the Administration has failed to tackle the structural deficit caused by out-of-control spending. These tax hikes will fall far short of reducing the deficit. Unless spending is controlled, massive tax hikes on the middle class are around the corner. There simply aren't enough rich people around to pay for all the government the current laws promise. That's why spending must be tackled now.

America's Top Tax Rate to Exceed Britain's.

For the first time in this century, the top tax rate in America will be higher than in England. Remember, the English economy stagnated for most of this century, while America prospered, largely because ruinous tax rates drove entrepreneurship and business in Britain into the ground.

The same policy that ruined England is now being proposed for this country -- including the idea of class war to turn the tax spenders against the taxpayers. It's ironic that just seven years ago this country led an international revolution toward lower tax rates on work effort, and is now moving in a reactionary fashion that will greatly harm our economy.

Federal marginal tax rates on upper income taxpayers, many of whom are not "rich," will reach as high as 40 to 42 percent and up to 44 to 48 percent when state taxes are considered.

During the campaign, the president promised a millionaire surtax, which now applies to income of $250,000 or more. Likewise the new tax bracket of 36 percent would apply to taxable income as low as $115,000 a year, instead of over $200,000 per year as indicated during the campaign.

We fear that these higher tax rates on upper income taxpayers are really a first step in soaking the middle class. We seriously doubt that the average American supports these new confiscatory tax rates. A poll conducted for the National Taxpayers Union Foundation last year found that an overwhelming majority of Americans, or 70%, agreed that "the highest federal income tax rate, on any part of a taxpayer's income, should not be higher than 25 percent."

Higher Tax Rates Will Harm Incentives to Work and Invest.

These higher tax rates will have far more effects than is apparently appreciated by the Administration. The higher tax rates will greatly harm incentives to work and invest. As a result, the revenue projections of the income tax hikes are far too optimistic. As Martin Feldstein has written, "taxpayers will find ways of converting taxable income into nontaxable income. Tax shelters and deferred compensation will become more attractive. And some individuals, especially in two-earner households, will opt to work less."

Feldstein notes that even a slight reduction in work effort can cause a loss in revenue to the government at these higher tax rates. For example, "at $180,000 of taxable income ... a very small 5% reduction in taxable income (to $171,000) for such individuals would mean a net reduction in total taxes paid: Although the Treasury would collect $2,594 of additional taxes on the income up to $171,000, it would lose $2,790 by not taxing the remaining $9,000 at the current 31% rates. The net effect would be a revenue loss of $196 instead of the projected revenue gain of $3,305. With a 10% reduction in taxable income (to $162,000), the higher rates would actually cost the Treasury $3,697."

Many investors will shift more of their investments toward tax-free bonds. How can that possibly help the economy? Some workers will decide to retire at an earlier age.

The tax hikes will accelerate in a trend of the growth of exurban towns, places far beyond the suburbs and even further from our nation's large cities. Why? Because the largest cities and suburbs are among the highest cost areas of the country. If you want to live well, that requires a higher income in higher-cost areas. But that income will be taxed at higher rates, giving more incentive to move to lower-taxed, lower-cost states to minimize the tax damage.

These higher tax rates will help enrich one class of professionals at the expense of the economy -- lawyers and accountants. Undoubtedly more higher income taxpayers will need professional help to simply calculate their tax or as they seek to convert regular income into tax-free perks or more lightly taxed capital gains income.

Higher Marriage Penalty Under Clinton Plan.

President Clinton says he supports high-skilled, high wage jobs. Yet one perverse effect of his proposal is to tax families where both spouses have high-skilled, high wage jobs. The marriage penalty would steeply increase for married couples earning roughly the same income, if each spouse's income is over $70,000 of taxable income per year.

Reason magazine editor Virginia Postrel notes that "during the 1980s, in fact, the biggest factor making household incomes unequal was the feminist revolution. Until recently, rich men's wives, if they worked at all, earned low wages at jobs that were essentially hobbies. Not until about 1979 did the wives of men in the top fourth of the income distribution make as much as the wives of the men in the bottom fourth. But by 1990, thanks to changing attitudes and increasing payoffs to education, they averaged 30 percent more, according to data by labor economist Kevin M. Murphy of the University of Chicago and Finis Welch of Texas A&M.

"Unleashing educated women into the workforce meant the rich got richer ... Since the existing marriage penalty doesn't deter enough working wives to prevent household inequality, increasing it looks like a reasonable place to start. But it still seems to prevent more marriages than careers ... Such are the absurdities of punishing productive people for their productivity. And that, at bottom, is what Clintonomics is all about."

Earned Income Tax Credit's Side Effects Loom Larger.

The Administration will propose an expanded Earned Income Tax Credit (EITC), but details are still sketchy. While we support many of the goals of the EITC, it is beginning to have serious and unappreciated side effects.

The phase-out of the earned income tax credit is creating apparent marginal tax rates that often approach 40 percent, and higher if the employer's share of Social Security is considered. Making the EITC more generous could create more disincentives to work at income levels. A substantial boost in the EITC would mean that these disincentives would apply to potentially many millions more workers, including many middle-class taxpayers.

Equally disturbing is the marriage penalty from a more generous EITC, especially an EITC that would apply to single individuals. While there is already a tax incentive for the working poor not to marry or stay married, such incentives could greatly increase under an expanded EITC. The last thing we need to do is to make the tax code more anti-family than it is today.

The Tax Package Hides and Understates the Tax Burden on the Middle Class.

This package appears to be the beginning of an attempt to soak America's middle class for higher taxes. The first step is to hit upper income taxpayers with sharply higher taxes, while discarding a middle class tax cut and replacing it with a tax increase on the middle class. The most important change that raises middle class taxes is a new broad-based energy tax, which purports to tax the heat content of certain major fuels.

According to the Treasury Department the energy tax proposal "would impose excise tax on fossil fuels (coal, oil, natural gas) at a basic rate of $0.257-per-million-Btus plus a $0.342-per-million-Btus supplemental tax on oil." The Treasury Department says the tax would be used for deficit reduction and to reduce environmental effects, promote energy conservation and reduce dependence on foreign energy sources. But these additional effects will be modest.

There is no substantial reason to tax oil at more than two times higher than other fuels. In most cases, combustion of oil is considerably cleaner than coal, yet oil is subject to a higher tax. The energy security benefits of such a tax differential are trivial.

This new tax is expected to raise the price of gasoline by 7-1/2 cents per gallon, while home heating oil is expected to go up by over 8 cents a gallon. Much if not all of the tax will be hidden in the form of higher prices, not only for home heating fuel and gasoline, but in every product manufactured and shipped in this country.

The Energy Tax Will Hurt American Exports.

The worst aspect of the energy tax lies in its potential to kill jobs. One of America's competitive advantages in the international arena is energy costs. By taxing energy, we're putting our exporters at a severe competitive disadvantage. That will result in lost sales or lower profits and lower wages or fewer jobs.

Strangely, the energy tax would hit hardest at some of America's hardest pressed industries, such as airlines, automobile manufacturers and agriculture.

The plan also proposes increasing the top income tax rate on large corporations to 36 percent. Yet inexplicably the President's tax burden tables assume that virtually none of this higher tax burden will be paid by middle class taxpayers. Tell that to consumers who have to pay higher prices in the stores, or workers who must sacrifice wage increases because of higher corporate taxes. The idea that a higher corporate tax rate is needed to prevent people from incorporating to take advantage of lower corporate rates is ridiculous. Lower corporate rates are still available for most small corporations, and will be unaffected by this change.

Social Security Tax Changes Are Unfair and Poorly Designed

The Administration's proposal also includes changes in the tax treatment of Social Security benefits. Under the proposal, up to 85 percent of Social Security benefits would be subject to tax, instead of the current 50 percent. While we are sympathetic with the goal of targeting Social Security benefits to the elderly poor, this tax scheme is riddled with flaws.

The 85 percent figure will strike many Social Security recipients as being arbitrary, and it is. It would be far more fair to put these benefits on a similar tax footing as benefits paid under private pensions. Subject Social Security benefits to tax, but only to the extent that the benefits received exceed the taxes paid into the Social Security system. While this is approximately 85 percent for many of today's recipients, it varies widely according to the recipient's retirement lifetime.

Taxing only the excess of benefits received over taxes paid is much more fair and would dramatically increase public understanding of the system. Many elderly believe the myth, created by years of government propaganda, that they only receive benefits that represent a return of their Social Security taxes. Taxing only the benefits that exceed taxes paid would help correct this myth. Each Social Security recipient should receive an annual statement from the Social Security Administration showing lifetime benefits paid to date compared to lifetime taxes paid. Only the excess would be subject to tax.

Such a statement would probably increase the willingness of today's better-off retired elderly to accept restraints in Social Security benefit payments. They would clearly see that Social Security benefits far exceed the taxes they paid into the system. And the tax treatment of the benefits, under this version of the proposal, would be perceived as being more fair.

Another problem with the proposed tax treatment of Social Security benefits is that it actually results in very high marginal tax rates on people who have saved for their retirement. It

would be far better to structure the taxation of Social Security benefits exactly like the taxation of all other forms of pension benefits.

Another proposal would "eliminate the dollar amount on wages and self-employment income subject to HI (hospital insurance) taxes for wages and income." This proposal is misguided, and will do nothing to help control Medicare costs. It would be far better and more effective to raise the awareness of Medicare costs for high-income Medicare recipients, rather than to increase taxes on today's workers. Today's higher income retirees have received far, far more in benefits than they have paid over a lifetime in taxes, whereas tomorrow's retirees will pay far more in taxes compared to today's retirees.

Some analysts have suggested a tax on the actuarial insurance value of the Medicare services. While this idea has some merit, it would be preferable to make changes that restrain the growth of benefits, while reducing the total cost of the program. One suggestion would be to make the deductible similar to the deductible for health costs now in the tax code, which is currently 7.5% of income, but only for income over a certain threshold. One option could be to apply an indexed deductible of $220 to all those earning less than $50,000 annually. Those earning over $50,000 could have a deductible of $220 plus 7.5% of the income earned over $50,000. For example, a Medicare beneficiary earning $100,000 in the previous year, would have a deductible of $220 plus $3750 (7.5% x $50,000), for a total of $3975.

Unfortunately, no one has estimated the cost of savings of such a proposal, but it clearly would save a substantial sum, while giving recipients clear incentive to control costs. Such a deductible linked to income should probably allow for payment for at least one doctor visit annually to encourage some basic preventative care.

This option would avoid higher marginal rates on today's younger workers while encouraging cost control among higher income Medicare beneficiaries.

Investment Incentives are Weak.

Finally, I would like to comment on two of the proposed tax measures that purport to encourage investment. These include a temporary incremental investment tax credit and a reduction of capital gains taxes for certain small business investments. Compared to the damage caused by the tax increase proposals, these and the other investment tax provisions would not do much to encourage economic growth. In our opinion, it would be far better to scrap the incremental investment tax credit and the permanent small business investment tax credit, and reduce the marginal tax rate increases, or apply them to higher income levels.

The Capital Gains Proposal Needs a Rollover Provision.

The capital gains reduction may provide more economic growth for the dollar of tax cut, but it is unnecessarily restrictive. The proposal requires investors to hold their stock for at least five years in order to exclude half of the gains. This proposal could be improved by allowing sale of such stock to qualify for preferential treatment if the proceeds were reinvested in another original issue stock from a qualifying corporation. This minor change would reduce the lock-in effect and encourage greater flow of capital to these small business start-ups and expansions. It would also encourage those investors who are best at the incubation process to roll over their investment into better opportunities, as they become available, instead of falling asleep for five years.

Conclusion.

Overall the President's proposals will harm economic growth and destroy jobs. At tax burden levels even remotely approaching today's levels, higher tax rates have never led to higher economic growth or creation of new jobs. By greatly increasing the prices American workers pay for working or taking risks, this program, if passed, would greatly undermine entrepreneurial activity and America's international competitiveness.

Mr. CARDIN. Mr. Santini will be accompanied by Mr. King.

STATEMENT OF JAMES D. SANTINI, COCHAIRMAN, CAMPAIGN TO KEEP TRAVEL COMPETITIVE, AND WASHINGTON REPRESENTATIVE, NATIONAL TOUR ASSOCIATION, ON BEHALF OF THE TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL, ACCOMPANIED BY AUBREY KING, EXECUTIVE DIRECTOR, TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL

Mr. SANTINI. Thank you.

We welcome this opportunity to testify on behalf of the Travel and Tourism Government Affairs Council. At the inception, Mr. King will share with the committee background facts and figures on the council's role and the scope of both the council and the travel and tourism industry.

Mr. KING. Thank you very much. I will try to keep this brief.

The council is a coalition of more than 30 national organizations that have a vital stake in issues affecting travel and tourism. Travel and tourism is indeed one of this country's most dynamic and diverse industries.

Sometimes we think that we are not sufficiently recognized or appreciated because of that very diversity, but travel and tourism runs the gamut from hoteliers to restauranteurs, to airlines, to travel agents, tour operators, operators of convention centers, a very wide gamut of people and businesses that have a stake in travel and tourism.

To be precise, it is a $360 billion industry in this country. It is our third largest retail industry generating more than 6 million jobs. It is the second biggest source of employment in this country. In 37 out of the 50 States, Mr. Chairman, travel and tourism is one of the first three providers of jobs.

During the 1980s it was one of the most dynamic creators of new jobs, generating jobs at a rate twice that of all the other manufacturing and service industries in the country. It is also our Nation's largest export. Visitors coming to this country from abroad spend more money here generating more foreign exchange earnings than any other single industry in this country.

Having said that, it must be realized that travel and tourism has been stagnant in the last 3 years, particularly on the domestic level. In fact, the average annual growth of domestic travel, which had been in the 7 to 8 percent range during the 1980s, has recently fallen to the 3 percent range. That is why, I suggest, many segments of our industry have recently been experiencing severe financial difficulty, probably best highlighted with the airlines, which have lost in the last 3 years $10 billion because of a decline in traffic.

The industry has been increasingly concerned with tax issues. We have never objected to paying our fair share of taxes nor objected to being treated equally along with other manufacturing and service-related industries.

We have objected to a growing tendency to look on travel and tourism, we think, as a source of funding for general government programs and to levy charges and taxes and fees that fall unfairly on travel and tourism in that regard.

To give you an illustration of the growth of this trend, in 1980 for every dollar spent on travel and tourism, approximately 10 cents went for taxes. In 1991, of every dollar spent on travel and tourism, 14 cents went for taxes, a 38 percent jump in tax burden over that period of time.

The council has worked in recent years to try to call to the attention of this committee and others in Congress the importance of travel and tourism and our concern with tax issues. That has been manifested in recent years by some very positive responses by this committee, notably in 1991, when the committee refused to approve a proposed increase in the gas tax and last year when, on at least two occasions, it refused to approve a proposed reduction in the business meal and entertainment deduction.

And finally, on that score, just to conclude my portion of this, let me say that we are concerned about the economic proposals that have been recently made by President Clinton. There are many elements there that we find ourselves in agreement with. But we are concerned about two tax proposals and I want to quickly refer to one, that is the business meal and entertainment issue.

You are going to be hearing a lot more about this issue in hearings in the next couple of weeks, but I would just suggest to you here that we regard this as an example, shall we say, of misguided populism. That is, it is very easy to talk disparagingly about the three martini lunch. What is not really sufficiently realized is that a business meal to many professionals and to many small businesses is simply an essential marketing tool. It is a way to come into contact with prospective clients and customers and we think not only would the burden of that proposed reduction from 80 percent to 50 percent fall unfairly on travel and tourism, but it is really unjustified and represents, we believe, a political failure to accept the reality that a business meal is not a throwaway, it is not a perk for the affluent, but is a legitimate marketing tool.

Thank you.

Mr. SANTINI. Continuing, we do commend the President for recognizing that timely and strategic public investment will play a vital role in stimulating job creation and ensuring the long-term vitality of our Nation. Most salient to travel and tourism is the proposed full funding of the Federal highway program at a level of $20 billion, utilizing the unspent cash balance in the Highway and Transit Trust Fund.

We are further gratified that Secretary of Transportation Peña has announced that the 2.5 cents of the motor fuel tax which, in 1990 was devoted to deficit reduction and was programmed to expire in 1995, will be continued thereafter but transferred into the highway account for that trust fund.

The travel and tourism industry is concerned, however, about two particular tax proposals. My colleague, Mr. King, has addressed one of those. I will examine the second, the energy tax. The proposed energy tax is broad based but treats oil differently from all other energy sources. By taxing oil at a rate more than twice as high as other forms of energy, it would place an especially heavy burden on fuel-dependent industries, such as travel and tourism.

In fact we submit that travel and tourism and trucking would probably suffer the most severe damage from this proposal. Phased

over 3 years beginning in July 1994 this proposed energy tax would be 25.7 cents per million Btu on natural gas, coal, nuclear power, and other energy sources. For oil, however, the tax would be an additional 34.2 cents per million Btu's, which would mean a total tax on oil of 59.9 cents per million Btu's, or 2.3 times the rate for all other fuels.

According to the U.S. Department of Energy, approximately 65 percent of all oil in this country is devoted to transportation purposes. For this reason, this oil surcharge amounts to a direct levy on transportation. In other words, our travel industry. It is a thinly disguised, direct tax on motor and jet fuel, and that jet fuel tax would be loaded upon an industry that is already laboring under, as my colleague observed, a $10 billion deficit over the last 3 years.

Also according to the Department of Energy, a tax of 59.9 cents per million Btu's equates to a tax of 8 cents per gallon of refined product, but according to the American Petroleum Institute, the impact would be much greater on motor and jet fuel. API points out that although other fuels can substitute for some oil uses, there are no substitutes for oil as a transportation fuel. Competitive forces also dictate that most of the burden will fall on the lighter fuels, gasoline, diesel, and jet fuel, at a rate between 10 and 15 cents per gallon.

The projected impact of this tax increase on that segment of the travel and tourism which has already suffered the heaviest economic losses, the airlines, shows how devastating this could be. The Air Transport Association, Mr. Chairman, and members of the committee, states that the tax would increase the cost of jet fuel from at least $400 million in 1994 to as much as $1.8 billion in 1996. While the impact could be mitigated by such modifications as altering the phase-in schedule and imposing the levy on refinery outputs of finished oil products, rather than on inputs, the crude petroleum, it would still have a disproportionate impact on travel and tourism.

Other speakers before this committee in the days ahead will explain how the proposed oil surcharge is regressive, that it penalizes those who must travel great distances because of where they live, those who depend on their automobiles for transportation because convenient public transportation is unavailable, and most of all will penalize those with lesser incomes who must spend a higher proportion of their income for fuel.

We at this time would only concur with those valid concerns. Our fundamental objection is derived from the nature of our industry. Travel and tourism is, by definition, dependent upon economical transportation. As we approach the end of the 20th century, our transportation depends on oil, and there are no substitutes.

We must strongly oppose those tax policies which discriminate against oil because those tax policies discriminate directly against travel and tourism. This, we submit, is unfair. This would, as a matter of Government policy, put travel and tourism in a competitive disadvantage in the marketplace.

Thank you, Mr. Chairman and members of the committee.

Mr. CARDIN [presiding]. Thank you, sir.

[The prepared statement follows:]

TESTIMONY BY HON. JAMES D. SANTINI
Travel and Tourism Government Affairs Council

The Travel and Tourism Government Affairs Council appreciates this opportunity to present the views of the United States travel and tourism industry on the President's economic stimulus proposals. The Council is comprised of representatives from every segment of the travel and tourism industry, including all modes of transportation, accommodations, food services, travel agents, tour sales and operations, attractions and recreation facilities, as well as state and local destination marketing organizations. The members of the Council are listed at the end of this statement.

Although we commend President Clinton for boldly moving to stimulate the economy and substantially reduce the Federal deficit, and we strongly support certain parts of his plan, we are concerned that at least two of the accompanying tax proposals would be detrimental to the travel and tourism industry, and counter-productive to the President's own stimulus goals because of their negative impact on economic growth and job creation.

The United States Travel and Tourism Industry: From Growth to Stagnation and Losses

We speak on behalf of one of the nation's most dynamic and diverse industries. Travel and tourism in America is a $360 billion industry (approximately 6.1% of GNP), making it our third largest retail industry after automobile dealers and grocery stores. It directly generates six million jobs and indirectly provides employment for another two and a half million -- making travel and tourism the nation's second largest employer, after health services. In thirty-seven states, travel and tourism is among the top three sources of jobs. During the 1980s, travel and tourism generated new jobs at a rate twice as great as that of all other American industries. Another compelling sign of the economic importance of travel and tourism is the fact that it has become our country's largest export; the money spent by international visitors to the United States makes travel and tourism our biggest earner of foreign exchange.

Although travel and tourism experienced robust growth during the 1980s, and international travel remains strong, the last three years have seen a dramatic decline in domestic travel growth. In 1988, the number of domestic person-trips (a "person-trip" is one person traveling 100 miles) rose 7.1% over 1987, but since then the rate of increase has declined to 3.2% in 1989, 2.9% in 1990 and only 3.8% in 1991. In the same fashion, the rate of annual increase for domestic travel expenditures declined from 8.6% in 1987 to only 1.7% in 1991. We suggest that these figures graphically define a stagnant, if not a declining domestic travel industry. This trend has been a major reason for the recent financial difficulties of the airline industry, which lost a staggering ten billion dollars in the three years from 1990 to 1992.

Taxes and Travel and Tourism

Travel and tourism has long been a major source of tax revenue for all levels of government. In 1991, $47.4 billion in total tax revenue was generated by travel and tourism ($26.8 billion in Federal taxes, $13.6 billion in state taxes and $7 billion in local taxes). The industry has always been ready to bear its fair share of that tax burden, which is "the price we must all pay for a civilized society." Travel and tourism has also been willing to support targeted taxes or "user fees" which are earmarked to pay for services or programs that provide particular benefits to the traveling public or the industry, e.g. a motor fuel tax to build better roads or an air ticket tax to improve the aviation system.

Unfortunately, in recent years, taxes on travel and tourism have increasingly become an excessive and disproportionate burden. In 1991, nearly fourteen cents of every dollar spent on travel and tourism went for taxes, compared to ten cents in 1980, a 38%

increase. Much of this increase has come from taxes paid exclusively or primarily by travel and tourism, but which are used to fund general revenue programs. The 1990 Budget Reconciliation Act, which enacted one of the largest tax increases in American history, obtained 15-20% of its new revenue from taxes targeting travel and tourism, with most of that revenue for the general fund, or deficit reduction purposes. For example, the two biggest tax increases on travel and tourism in that 1990 legislation were the nickel a gallon increase in the Federal motor fuel tax, with two and a half cents going to deficit reduction, and the 25% increase in the air ticket tax, all of which was dedicated to deficit reduction.

The travel and tourism industry has become increasingly concerned about these tax trends. Through the Travel and Tourism Government Affairs Council, the industry has worked to explain to tax policy-makers the threat to its continued growth posed by excessive taxation. Although Americans love to travel, to explore and experience new places and new people, for most of us, most of the time, travel is a discretionary expenditure, and one that is in direct competition with different forms of communication and different leisure experiences. The message we have tried to convey is that for the government arbitrarily to impose additional travel costs, adding further to the cumulative cost of travel, is to create an unfair disincentive, to make travel less competitive. To communicate this message more effectively, the Council has established a new "Campaign to Keep Travel Competitive" by supporting more rational and equitable tax policies. This campaign is being supported by companies from all segments of the travel and tourism industry, who see their economic vitality increasingly threatened by new, arbitrary and unfair tax burdens.

Since 1990, the Ways and Means Committee has responded positively to the tax concerns raised by the travel and tourism industry. Thus, in the summer of 1991, the Committee rejected an attempt to raise the Federal motor fuel tax another nickel a gallon to help fund the Intermodal Surface Transportation Efficiency Act of 1991. Then, last spring, the Committee rejected an attempt to lower the deductibility of business meals. The Committee wisely understood in both 1991 and 1992 that the additional revenue generated by these two proposals would have been more than offset by their negative impact on jobs and economic growth.

The President's Economic Stimulus Proposals

We commend the President for recognizing that timely, strategic public investments will play a vital role in stimulating job creation and ensuring the long term economic vitality of our nation. Most salient to travel and tourism is the proposal fully funding the Federal highway program at a level of $20.6 billion. This will help put to work part of the more than $20 billion unspent cash balance in the Highway and Transit Trust Fund, helping to spur economic growth, transportation productivity, and the international competitiveness of American businesses. It is self-evident that the travel and tourism industry is vitally dependent on the most efficient and economical modern transportation system.

We are further gratified that Secretary of Transportation Pena has announced that the two and a half cents motor fuel tax which in 1990 was devoted to deficit reduction will be extended beyond its scheduled 1995 expiration with the revenue thereafter transferred into the highway account of the trust fund. We applaud this recommitment to the historic principle that revenue from the motor fuel tax should be exclusively devoted to the highway program.

The travel and tourism industry is concerned, however, about two particular tax proposals that have been included in the economic stimulus plan.

The Energy Tax

The proposed energy tax is broad based, but treats oil differently from other energy sources. By taxing oil at a rate more than twice as high as all other forms of energy, it would place an especially heavy burden on fuel dependent industries, such as travel and tourism. In fact, we submit that travel and tourism and trucking, would probably suffer the most severe damage from this proposal.

Phased in over three years beginning in July, 1994, the proposed energy tax would be 25.7 cents per million British Thermal Units (BTUs) on natural gas, coal and nuclear power. For oil, however, the tax would be an additional 34.2 cents per million BTUs, which would mean a total tax on oil of 59.9 cents per million BTUs, or 2.3 times the rate for all other fuels.

According the United States Department of Energy, approximately 65% of oil in this country is devoted to transportation purposes. For this reason, this oil surcharge amounts to a direct levy on transportation, in other words on the travel industry. It is a thinly disguised direct tax on motor and jet fuel.

Also according to the Department of Energy, a tax of 59.9 cents per million BTUs equates to a tax of eight cents per gallon of refined product. But according to the American Petroleum Institute (API), the impact would be much greater on motor and jet fuel. API contends that because other fuels can substitute for some uses of oil, whereas there are no substitutes for oil as a transportation fuel, competitive forces will dictate that most of the burden will fall on lighter fuels, gasoline, diesel and jet fuel, at a rate between ten and fifteen cents per gallon.

The projected impact of this tax increase on that segment of travel and tourism which has recently suffered the heaviest economic losses -- the airlines -- shows how devastating it could be. According to the Air Transport Association, the tax would increase the cost of jet fuel from at least $400 million in 1994 to as much as $1.8 billion in 1996.

While the impact could be mitigated by such modifications as altering the phase-in schedule and levying the levy on refinery outputs (finished oil products) rather than inputs (crude petroleum), it would still have a disproportionate impact on travel and tourism.

Other speakers before this Committee in the days ahead will explain how this proposed oil surcharge is regressive, that it penalizes those who must often travel great distances because of where they live, and those who must depend on their automobiles for transportation because convenient public transportation is unavailable. Most of all, it would penalize those with lesser incomes who must spend a higher proportion of their income for fuel. We at this time would only concur with those valid concerns.

Our fundamental objection is derived from the nature of our industry. Travel and tourism, by definition, is dependent on economical transportation. As we approach the end of the twentieth century, our transportation system depends on oil; there are no substitutes. We must strongly oppose tax policies which discriminate against oil because those tax policies discriminate, however inadvertently, against travel and tourism. This, we submit, is unfair. This, as a matter of government policy, puts travel and tourism at a competitive disadvantage in the marketplace.

The Business Meal and Entertainment Deduction

Of additional concern is the proposal to reduce the deductibility of business meals and entertainment from the current level of 80%

to a lower level of 50%. While we support the President's goal of distributing the economic burden as equally as possible among all Americans, this proposal would have the opposite effect. Like the oil surcharge, it would have a severely disproportionate impact on the travel and tourism industry. It would place thousands of food service jobs at risk because it would discourage companies from using business meals and entertainment as marketing tools. Currently, more than nine million people are employed in the food service industry (those millions who service local customers are not counted as travel and tourism employees), including more women and minority managers than in any other industry. Many of these jobs represent a "safety net," providing income for individuals who have been economically dislocated by other industries.

The negative impact would extend throughout many other segments of travel and tourism, as reduced tax deductions would make business trips more expensive, thus resulting in fewer airline tickets being bought, fewer hotel rooms being used, fewer cars being rented and fewer conferences and meetings held in convention centers and elsewhere.

Although some perceive lowering the business meal deduction to have "populist appeal," the facts show that business meals are far from an exclusive "perk" enjoyed only by the affluent. Not only are such deductions widely claimed by small businesses and single proprietors, but seventy percent of those who claim the deduction, according to a 1989 survey, had annual incomes below $50,000. Furthermore, that same survey showed that seventy-eight percent of business lunches (50% of business dinners) occur at low and moderately priced restaurants.

Finally, we suggest that it is unfair to treat business meals differently under the tax code from other legitimate business expenses. Business meals are most often simply another form of marketing, often the most efficient form of marketing, that should be just as deductible by a company or an individual as any other marketing expense.

Summary and Conclusion

The United States travel and tourism industry is striving to recover from several recent years of stagnation. Major segments of this industry, notably the airlines, have suffered enormous losses during this period.

While travel and tourism commends the President's proposed increased investment in our transportation infrastructure and applauds the commitment to use all the Federal gas tax revenue in the highway trust fund in 1995, the industry is greatly concerned that the proposed oil surcharge and reduction in the business meal deductibility will have a severely negative and unfair impact on its job creating potential and economic growth prospects.

TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL MEMBERSHIP

MEMBERS

Air Transport Association
Airports Council International
American Automobile Association
American Bus Association
American Car Rental Association
American Council of Highway Advertisers
American Hotel & Motel Association
American Recreation Coalition
American Sightseeing International
American Ski Federation
American Society of Travel Agents
Association of Retail Travel Agents
Gray Line Worldwide
Highway Users Federation
Hospitality Sales and Marketing Association International
International Association of Amusement Parks and Attractions
International Association of Convention and Visitor Bureaus
International Council of Cruise Lines
Meeting Planners International
National Air Carrier Association
National Association of RV Parks & Campgrounds
National Business Travel Association
National Caves Association
National Council of Area and Regional Tourism Organizations
National Council of State Travel Directors
National Council of Travel Attractions
National Council of Urban Tourism Organizations
National Park Hospitalty Association
National Restaurant Association
National Tour Association
Passenger Vessel Association
Recreation Vehicle Industry Association
Society of American Travel Writers
Society of Travel Agents in Government
Travel Industry Association
United States Tour Operators Association
U.S. Travel Data Center

Mr. CARDIN. Mrs. McSteen.

STATEMENT OF MARTHA A. McSTEEN, PRESIDENT, NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

Ms. MCSTEEN. Thank you, Mr. Chairman. I am Martha McSteen, president of the National Committee to Preserve Social Security and Medicare. I will comment very briefly on taxation of benefits, Medicare changes, entitlements and tax breaks. The committee supports the kind of serious deficit reduction proposal that the President has made, although we do feel that senior citizens are at this time singled out to pay a disproportionate share of the deficit reduction.

The proposed cuts on top of the proposed energy tax calls seniors to question whether the economic plan is fair to low- and middle-income Americans particularly. First let's talk about taxes on Social Security benefits. The President's plan would raise income taxes on senior Americans with little more than $25,000 in income. The proposal alludes to the 1.2 percent of American families who will have an increase in their income tax rates, yet 23 percent of seniors will have an income tax increase.

If program changes that could affect the Social Security system in the future are needed to adjust to cultural and financial changes, these recommendations can best be made by the Advisory Council on Social Security. The assumption underlying the President's proposal to tax up to 85 percent of benefitsis that it would move the treatment of Social Security benefits toward that of a private pension. But Social Security benefits are not analogous to a private pension. Unlike private pensions, the Social Security benefit formula is progressive. There is no comparable method of comparing the two.

Second, let me talk just a minute about the Medicare issues. Judged alone, the Medicare proposals appear to be more of the same kinds of proposals which Congress has rejected in the past. The increases in part B premiums will add more than $150 a year to all but the poorest seniors' health care costs by 1998. Reductions in payments to doctors and hospitals will exacerbate the existing payment differentials between Medicare and the private sector.

Certainly the President's heart is in the right place on health care reform, but, until the overall health care reform plan can be evaluated and passed as a package, individual changes should not be enacted.

Third, there are misconceptions about entitlements. Support for the current proposals would not be as strong if it weren't for the erroneous but conventional wisdom that entitlement programs, like Social Security and Medicare part A, are causing the deficit. A decade ago there was some truth to that argument, but the Congress, with strong leadership from this committee, acted to control Social Security costs.

The only entitlements in which costs are currently rising as a percentage of the gross domestic product are the health care entitlements. Reforming the health care system will bring both private and public health care spending under control. To either cut benefits or make more Social Security benefits liable for taxation now

simply allows more of the deficit in the general fund to be financed by the Social Security trust fund surplus.

The National Committee fears that this continued use of Social Security surpluses to finance current consumption by the Federal Government will undermine the system and could result in serious problems when it comes time to draw down surpluses to pay Social Security benefits for the baby boom generation.

The significant attention to Social Security spending that is fully financed by payroll taxes is surprising, given the little scrutiny to those who receive tax breaks or tax benefits which the Government gives away. In fiscal year 1994, OMB estimates that tax benefits will cost Government more than $479 billion in revenue, which is almost double the projected deficit. Exclusion of employer contributions for medical insurance premiums and pension contributions for employer plans are examples.

In conclusion, let me say that the National Committee applauds the efforts of the President and Congress to reduce the deficit, but we urge you to fully consider the effects on seniors of increasing the taxation of benefits and premium increases. These increases, along with the proposed energy tax, may indeed be too burdensome.

Thank you, sir.

[The prepared statement follows:]

National Committee to
Preserve Social Security
and Medicare

Statement of Martha McSteen
President
National Committee to Preserve Social Security and Medicare

Presented to:
Committee on Ways and Means
U.S. House of Representatives

March 16, 1993

Regarding the President's Economic Plan

I am Martha McSteen, President of the National Committee to Preserve Social Security and Medicare, which represents approximately six million members and supporters—most of whom receive Social Security and Medicare benefits. I am pleased to appear before the Ways and Means Committee today to discuss the Administration's budget proposals. The National Committee clearly supports the serious deficit reduction proposal the President has made. Yet we feel that senior citizens are singled out to pay a disproportionate share of the deficit reduction principally through proposals to increase the amount of Social Security benefits subject to income taxation and to cut the Medicare program.

National Committee members understand that deficit reduction is not painless; it requires shared sacrifice. National Committee members appreciate the President's request to look at the whole package—not just the budget cuts and tax increases that adversely impact seniors.

When we look at the whole package—these two cuts on top of the proposed energy tax—we wonder whether the economic plan is fair to all seniors. The President's efforts to help low income families hurt by parts of his plan will probably not do enough for senior Americans. Increased spending for the Low Income Home Energy Assistance Program and the Food Stamp program will help some low income seniors hurt by the energy tax, but low income seniors will benefit little from the expansion of the earned income tax credit.

Increase Tax on Social Security Benefits

The President's commitment to fairness needs to also be refined with respect to his proposal that middle and upper income senior citizens pay an average of $483 in additional taxes on their Social Security benefits. That means middle and high income seniors will pay more in taxes than under-age-65 individuals with comparable incomes.

While the Administration proposes to raise income taxes on most Americans only with income over $100,000, the President's plan would raise income taxes on senior Americans with little more than $25,000 in income. The President said that only 1.2 percent of America's families will have an increase in their income tax rates, yet 23 percent of seniors will have an income tax increase.

And it will only get worse. "Bracket creep" has been eliminated for every taxpayer except Social Security beneficiaries. Every year more and more beneficiaries have to pay taxes because the thresholds for taxing Social Security benefits have not been indexed. As a result, the Administration's statement that "maintaining the existing income thresholds protects most low- and middle-income beneficiaries from benefit taxation"[1] will be less and less true over time for older Americans. In 1994, 23 percent of beneficiaries will pay tax on benefits. By 1998, 30 percent of beneficiaries will be paying tax on benefits.

Most of those who are 25 today can expect to pay tax on benefits when they retire under current law. And because the threshold for married couples is

[1] A Vision of Change for America, February 17, 1993, p. 101.

only 28 percent higher than that for individuals, married couples are more likely to pay tax on benefits, especially if one is still in the work force.

There are unintended consequences of the economic package. Workers are encouraged to save for their retirement to supplement Social Security. Now they are unexpectedly being taxed if they did what they were encouraged to do.

And that is not the only way they lose. Pension plans usually take into account what a worker can expect to receive from Social Security, but pensions won't be automatically adjusted if benefits are taxed. In other words, taxing more of Social Security benefits means retirees will receive less in after tax income from their pensions and Social Security than was planned and anticipated.

The National Committee is especially concerned that this proposal may undermine the long-term viability of Social Security. Solidarity and public support for Social Security exists when all workers believe they are receiving a reasonable return on their Social Security taxes. If program changes are needed to adjust to cultural and financial changes, these recommendations should best be made by the quadrennial Advisory Council on Social Security.

The assumption underlying the President's proposal is that taxing up to 85 percent of benefits "would move the treatment of Social Security and Railroad Retirement Tier I benefits toward that of a private pension."[2] But Social Security benefits are not analogous to a private pension.

Unlike that of private pensions, the Social Security benefit formula is progressive. In 1994, the average earner will receive approximately 43 percent of his or her average earnings, but the maximum earner will only get 25 percent. If a maximum earner's benefit of $1,156 in 1994 was determined by the same formula as an average earner, his or her benefit would be $2,003 a month. That is an $847 a month difference. There is no comparable progressivity in calculating a private pension.

There's another reason why taxing Social Security should not be compared to taxing private pensions. Under current law, the government fully taxes private pensions except for the nominal value of the original employee contribution. It does so even though inflation means the original contribution is worth a lot more in today's dollars. In order to correct this inequity, the Department of the Treasury in 1984 proposed to exclude from taxable income not only the nominal employee contribution to a private pension but also the inflation adjusted value. While this proposal was not adopted, the reasoning behind it is still valid. Just because private pensions are overtaxed now doesn't mean that Social Security benefits also should be overtaxed.

Medicare Cuts

It is harder to pass judgment on the proposed Medicare cuts until the President presents his health care reform plan in May. All seniors, except those with low income, will pay more in Medicare Part B premiums—$150 a year more by 1998. Judged alone, the proposals to reduce payments to doctors and hospitals appear to be more of the same kinds of proposals that Congress rightly has rejected year after year. These reductions will exacerbate the existing payment differentials between Medicare and the private sector which jeopardize health care access for Medicare beneficiaries and put pressure on health care prices for the private sector. That would be a disaster, for seniors but and all Americans concerned about access to health care and cost containment.

Certainly the President's heart is in the right place on health care reform. But until the overall health reform plan can be evaluated and passed as a package, individual changes that exacerbate current cost shifting should not be enacted.

Misconceptions About Entitlements

The first part of my statement focused on the specific administration proposals' to cut Social Security and Medicare. Support for these proposals, however, would not be as strong if it weren't for the erroneous but conventional wisdom that "entitlement" programs, AKA Social Security and Medicare, are causing the deficit. A decade ago, there was some truth to this argument. But the Congress with strong leadership from this Committee acted to control Social Security costs.

The only entitlements in which costs are currently rising as a percentage of the Gross Domestic Product are the health care entitlements. As this Committee well knows, rising costs for federal health care entitlements, such as

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[2]A Vision of Change for America, p.101.

Medicare and Medicaid, are primarily driven by rising health costs. Reforming the health care system will bring both public and private health spending under control.

Social Security and other social insurance programs pay benefits on the basis of earned rights through years of contributions. Beneficiaries have earned their entitlement. Social Security is self-funded. Advocates of reducing Social Security benefits assume workers would willingly pay the Social Security payroll tax even if the surplus was diverted to pay for non Social Security programs. That is not the case.

Social Security is now turning a profit for the federal government—$55 billion this year. Every dollar of the Social Security trust fund surplus goes to finance the deficit in the general fund. The proposed increase in taxation of Social Security benefits is not needed because Social Security is not adding to the deficit.

To either cut benefits or make more Social Security benefits liable for taxation now simply allows more of the deficit in the general fund to be financed by the Social Security trust fund surplus. The National Committee fears that this continued use of Social Security surpluses to finance current consumption by the federal government will undermine the system and could result in serious problems when it comes time to draw down surpluses to pay Social Security benefits for the baby boom generation.

The significant attention to Social Security spending that is actually financed by payroll taxes is surprising given the little scrutiny given to those who receive tax breaks or tax benefits which the government gives away. In fiscal year 1994, OMB estimates that tax benefits will cost the government $479 billion in revenue, which is almost double the projected deficit. Incidentally, it is also over $200 billion more than Social Security is spending. And unlike Social Security spending which is progressive, those who benefit from tax breaks are more likely to have high income. These tax breaks also are worth more to higher income individuals who are in marginal tax brackets of 28 or 31 percent or higher under the President's proposal.

What Windfall

Cutting back on Social Security benefits, especially for higher income beneficiaries, is frequently justified as reducing the so called "windfall" that today's Social Security beneficiaries receive. By windfall, most critics mean that beneficiaries receive more in benefits than they (and their employers) have contributed. Beneficiaries have not "earned" their benefits according to this argument and should stop fighting the cuts being proposed.

Beneficiaries, however, wonder why they should become victims of arbitrary retroactive accounting. They paid the taxes required of them at the time to earn benefits. And Congress wanted benefits to be adequate. As a result, the poverty rate of seniors today is only 12 percent. Without Social Security, almost half of all seniors would be considered poor.

The so-called windfall for the worker retiring today is grossly exaggerated. If both the employer and employee tax are considered, the windfall for workers retiring today is small compared to workers retiring ten or twenty years ago, and workers retiring in ten years will have little or no windfall at all.[3] Yet the taxation of Social Security benefits, which will affect future beneficiaries even more than today's beneficiaries, is being justified on the basis of today's supposed windfall.

Conclusion

The National Committee applauds the efforts of the President and Congress to reduce the deficit, but we urge you to fully consider the effects on seniors of increasing the taxation of benefits and premium increases. These increases, along with the proposed energy tax, may indeed be too burdensome. We don't believe that it is the President's intention for one group, senior citizens, to pay such a disproportionate share of the sacrifice he has asked of all Americans.

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[3]Robert J. Myers and Bruce D. Schobel, "An Updated Money's-Worth Analysis of Social Security Retirement Benefits," Transactions of the Society of Actuaries, Vol. XLIV, forthcoming.

Mr. CARDIN. Let me thank all of our panelists. As you may have heard, the bells have gone off, which means that some of our colleagues had to leave in order to vote on the floor. For different reasons, each of you have expressed some concerns about the President's package.

I am wondering whether you have any specific changes you would like to see made that would not increase the deficit as calculated by CBO, and if you do, I would appreciate being specific and not just saying cut spending or something like that, if you would give us a specific suggestion or change that you would like to see.

I note, Mr. Zah, you indicated you would like to see more incentive. The President has certain incentives in his package that I would think could be very helpful, the investment tax credit or the enterprise zones or the small business credit.

If you would like to see more, how are we going to pay for it? I guess I will just give you a general question, how would you improve the package, any one of you, but yet not add to the deficit?

Mr. KEATING. I will be happy to take a crack at that.

Mr. CARDIN. I knew that you would, Mr. Keating.

Mr. KEATING. Well, first I would scrap all the tax increases in the package and I would also scrap the stimulus investment spending and that would take a good bite out of the deficit. But even in the testimony here today——

Mr. CARDIN. That would still add significantly—using the CBO figures, if we scrapped all the revenue provisions and scrapped all the stimulus package, it would increase the deficit significantly over what the Clinton proposal would do.

Mr. KEATING. Right. That is just step one. We are glad to see the defense spending cuts the President has proposed. We would still like to see the details, but we think the size of them are certainly in order and we would support that. We support a lot of the other provisions in his package, especially those that curtail business subsidies and subsidies that hurt the environment. We are 100 percent in support of those proposals. The Social Security package, as I mentioned in the testimony, could be improved by the statement given to each beneficiary.

We have also recommended changes in Federal pensions, such as raising the retirement age. We also think it would be better to move toward a defined contribution plan rather than a defined benefit plan that we have today. That would give people that work in the bureaucracy an incentive to help create economic growth with the actions that they take, within the law of course.

Also in my written testimony, we suggest that instead of raising the tax rate on health insurance for Medicare, Congress should raise the deductible for Medicare based on income. There is no reason why someone like Ross Perot, for example—I don't know his age, but when he is old enough—he certainly doesn't need Medicare to pay his health costs so we think it would be a good idea to have a deductible for Medicare based on income.

The Tax Code, for example, says that your medical expenses have to exceed 7.5 percent of your income before you can claim a deduction. Perhaps 7.5 percent is a good figure after $50,000 of income.

Those are just some of the proposals we could suggest. Congress could also abolish many other business subsidies, including the agricultural subsidies.

Mr. CARDIN. We are going to have to adjourn the hearing. I invite any of the other members of the panel to submit specifics. We would very much appreciate your help in trying to deal with improving the President's package, but we would urge in any suggestions that you bring forward that the net impact would be at least as strong on deficit reduction, if not stronger.

I do apologize that we are not going to be able to continue the hearing at this point because of the requirements to be on the floor for voting. I want to thank the panel for their participation and assure you that your full statements will be closely scrutinized by the Ways and Means Committee. Thank you all very much.

[Whereupon, at 1:55 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, March 17, 1993.]

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

WEDNESDAY, MARCH 17, 1993

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. Good morning. Today we continue our series of hearings on President Clinton's economic and deficit reduction plan. First, we will hear from two Members of Congress on their views of the President's package, then we will receive testimony from the Secretary of State of the Commonwealth of Puerto Rico. Then we will hear from several professional associations that have a particular interest in the passage of the administration's tax laws, including the American Bar Association, the American Institute of Certified Public Accountants.

In addition, we will hear from a panel of major business and trade associations. We expect that they will address the various business provisions of the President's plan, including the investment tax credit, the research and development tax credit, and proposed changes to the alternative minimum tax.

Further, we will hear from the representatives of our Nation's ports and waterways and from those who use our waterways to ship commodities. These witnesses are expected to testify about the administration's proposed increase in inland waterways fees.

It is a pleasure for me at this time to welcome the Honorable Eleanor Holmes Norton, a Member of Congress from the District of Columbia. Eleanor, welcome to the committee. If you are ready to proceed, the committee is ready to take your testimony.

STATEMENT OF HON. ELEANOR HOLMES NORTON, DELEGATE TO CONGRESS FROM THE DISTRICT OF COLUMBIA

Ms. Holmes. I am, Mr. Chairman, and thank you very much. I am happy to support the permanent extension of the alternative minimum tax exception for contributions of appreciated tangible property to charitable organizations which I shall henceforth refer to as AMT in my testimony .

I am not here only because I am an unapologetic art lover and a member of the Congressional Arts Caucus or because I am still a law professor and believe that universities need and deserve this change.

Actually I became interested in this tax deduction literally by reading some materials on the flight of art from the United States. Although the District of Columbia is the home of great art museums, I had never been lobbied on this issue. This is not, of course, the kind of tax break that most readily comes to mind in a district that has more than its share of poor people. However, it should come to mind. If there continues to be a structural decline in the collections of the great museums and donations of property to universities, many more than the rich will be affected.

In the District of Columbia alone there are 30 museums and 13 colleges and universities whose ability to attract donations of artifacts and other gifts in turn provides them with the ability to provide jobs that drive vital sectors of our economy, such as tourism and education. If wealthy taxpayers must donate art stocks and real estate to nonprofit groups at a tremendous loss to themselves because the tax deduction is based on the original purchase price rather than the current market value, there is an almost irresistible economic imperative to go elsewhere.

Any focus on the benefit to rich people alone misses the mark. Of course, the wealthy benefit from tax breaks. The benefit to the wealthy is obvious, and I must say classically American in our economy. There is a critical missing part of the equation that looks only to the benefactor, however. The largest number of beneficiaries of the expansion of the AMT would be American museums, universities, and conservation groups.

What of the harm done in denying the permanent extension? The harm has been precipitous and dangerous. It was as if the Congress had set out to force the United States to become a third-rate art repository by driving great art works, native and otherwise, offshore. Did Congress really mean the National Museum of Art to have a 90-percent reduction in gifts in a single year between 1990 and 1991? Was our intention that the Los Angeles Museum of Art in the first half of 1992 under relaxed restrictions attract art worth $13.2 million, while in the second half under stricter rules only $4 million in gifts were donated? Surely we did not intend that the Hirschhorn Museum receive 36 contributions in 1991 under the more favorable tax conditions as compared with only 8 in 1990 or that the National Portrait Gallery here receive 494 gifts in 1991 as compared to only 68 in 1990. Seldom has a single change in the Tax Code had such a dramatically harmful and immediate effect. According to the American Association of Museums, donations fell by more than 80 percent.

Nor do I agree with critics who say that this provision does not belong in a stimulus plan. In effect, unless this change is made permanent, we are asking museums which are already struggling to meet daily operating expenses to divert funds to acquisitions rather than to employ people. Even the great Smithsonian for the first time has resorted to putting out donation boxes to beg funds from the public that has always supported it through Government appropriations alone.

There is palpable good at stake here. The AMT has shown its enormous power to attract gifts of art to the public domain for the benefit of all and other assets from private hands for public good. Beyond the AMT's power, the most recent experience demonstrates

that AMT is quite simply indispensable to the viability of many vital institutions in this country. The estimated $295 million in forgone revenue over the next 5 years is a pittance by comparison. The 18-month window of opportunity during which dramatic increases in donations to art museums occurred is the best before and after snapshot of public policy effects I have seen in a long time. It speaks volumes for itself.

The Tax Reform Act of 1986 was a good law. It was not a perfect law, as I think the outcomes I have described amply illustrate. Unlike the situation in many industrialized European and Asian countries, in this country relatively few public subsidies exist. However, Americans have allowed, even welcomed, tax incentives as a way to accomplish at least some of the income and benefit transfer that otherwise simply would not occur. No tax reform should be so sweeping as to do active harm to universities, museums, and similar vital institutions. That has been the unintended effect of the 1986 provision. I believe that the President has found the right remedy, and I strongly urge its permanent extension. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF CONGRESSWOMAN ELEANOR HOLMES NORTON BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS IN SUPPORT OF PRESIDENT CLINTON'S PROPOSAL TO MAKE PERMANENT THE ALTERNATIVE MINIMUM TAX EXCEPTION FOR CONTRIBUTIONS OF APPRECIATED TANGIBLE PROPERTY TO CHARITABLE ORGANIZATIONS

March 17, 1993

I am here to strongly support the permanent extension of the Alternative Minimum Tax Exception for Contributions of Appreciated Tangible Property to Charitable Organizations (AMT). I am here not only because I am an unapologetic lover of art and a member of the Congressional Arts Caucus or because I am still a law professor and believe that universities need and deserve this change. I am here to urge the Committee to support the President's extension proposal and thus to correct a provision of the tax code that had good intentions but has produced unintended bad effects.

Actually, I became interested in this tax deduction literally while reading some materials on the flight of art from museums and even from the United States. Although the District of Columbia is the home of great art museums, I had never been lobbied on this issue. This is not, of course, the kind of tax break that most readily comes to mind in a district that has more than its share of poor people. However, it should come to mind. If there continues to be the serious structural decline in the collections of the great museums and donations of property to universities, many more than the rich will be effected.

In the District of Columbia alone there are 30 museums and 13 colleges and universities, whose ability to attract donations of artifacts and other gifts in turn provides them with the capacity to provide jobs that drive vital sectors, such as tourism and education. If wealthy tax payers must donate art, stocks, and real estate to non-profit groups at a tremendous loss to themselves because the tax deduction is based on the original purchase price rather than the current market value, there is an almost irresistible economic imperative for gifts to go elsewhere.

Any focus on the benefit to rich people alone misses the mark, however. It goes without saying that the wealthy benefit from tax breaks, a classically American feature of our economy. There is a critical missing part of the equation that looks only to the benefactor, however. The largest number of beneficiaries of the permanent extension of the AMT would be American museums, universities and conservation groups.

What of the harm in denying the permanent extension of the alternative minimum tax exception? The harm has already been precipitous and dangerous. It was as if the Congress had set out to force the United States to become a third rate art repository by driving great works of art, native and otherwise, off shore. Did Congress really mean the National Museum of Art to have a 90% reduction in gifts in the single year between 1990 and 1991? Was it our intention that the Los Angles Museum of Art in the first half of 1992 under relaxed restrictions attract art worth $13.2 million, while in the second half under stricter rules, only $4 million in gifts were donated? Surely, we did not intend that the Hirshhorn Museum receive 36 contributions in 1991, under the more favorable tax conditions, as compared with only 8 in 1990, or that the National Portrait Gallery receive 494 gifts in 1991, as compared with only 68 in 1990. Seldom has a single change in the tax code had such dramatically harmful and immediate effects. According to the American Association of Museums, donations to its member institutions fell by more than 80%.

Nor do I agree with critics who say that this provision does not belong in a stimulus plan. In effect, unless this change is made permanent, we are asking museums that are already struggling to meet daily operating expenses to divert funds to acquisitions rather than to employ people. Even the great Smithsonian for the first time has resorted to putting out donation boxes to beg funds from the public which has always supported it through government appropriations alone.

There is a palpable public good at stake here. The AMT has shown its enormous

power to attract gifts of art to the public domain for the benefit of all and other assets from private hands for public good. Beyond the power of the AMT, the most recent experience has definitively demonstrated that the AMT is indispensable. The estimated $295 million in foregone revenue over the next five years is a pittance by comparison to the public benefits. The 18-month window of opportunity during which dramatic increases in donations to art museums occurred is the best before-and-after snapshot of public policy effects I have seen in a long time. It speaks volumes for itself.

The Tax Reform Act of 1986 was a good law. It was not a perfect law, as I think the outcomes I have described amply illustrate. Unlike the situation in many industrialized European and Asian nations, in this country relatively few direct public subsidies exist. However, Americans have allowed, even welcomed, tax incentives as a way to accomplish at least some of the income and benefit transfers that otherwise simply would not occur. No tax reform in this country should be so sweeping as to do active harm to universities, museums and similar institutions. This has been the unintended effect of AMT. I believe that the President has found the right remedy, and I strongly urge permanent extension.

Chairman ROSTENKOWSKI. Are there any questions of Ms. Norton? If not, thank you very much for your participation.

The Honorable Carlos Romero-Barceló. Is it possible, Mr. Congressman, that we put the Secretary of State on with you or would you prefer to——

Mr. ROMERO-BARCELÓ. I have no problem at all.

Chairman ROSTENKOWSKI. Mr. Secretary, the Honorable Baltasar Corrada Del Rio, the Secretary of State. Carlos, if you are ready to go, we are ready.

STATEMENT OF HON. CARLOS A. ROMERO-BARCELÓ, RESIDENT COMMISSIONER IN CONGRESS FROM PUERTO RICO

Mr. ROMERO-BARCELÓ. Yes, we are ready.

Mr. Chairman, members of the Ways and Means Committee, I am here today as the sole elected representative in Congress of 3.6 million U.S. citizens in Puerto Rico, six times the number of constituents represented by any other Congressman. I appear before you to address those provisions of President Clinton's deficit reduction and economic stimulus proposal that will impact on all 50 States and on Puerto Rico. Specifically, the proposed changes to section 936 of the Internal Revenue Code will have a particular effect on Puerto Rico.

This committee meets at a time when a climate of fear exists among the people of our island. A great deal of that fear has been stimulated and created by a group of federally tax-exempt corporations and their special interest tax-exempt organizations, such as the Puerto Rico Manufacturers' Association, which would have our people believe that our economy and its development depend exclusively on section 936. Have you noticed the full-page advertisements by these corporations? If you believe them, you would think that the salvation and future of Puerto Rico hinges on not making any changes whatsoever to section 936. In other words, that those corporations which now earn billions of tax-exempt dollars be allowed their free ride forever, while small businesses, the hard-working middle class, and the low-income families are asked to bear the burden.

As some of you know, I am a former two-term mayor of San Juan and a former two-term Governor of Puerto Rico. In two decades of public service, never have I witnessed such a torrent of wild claims, distortions, and exaggerations of the real impact of any proposed changes in the existing section 936 of the Internal Revenue Code.

And you will undoubtedly hear more of them in the coming weeks and months.

It is against this backdrop, against the fact that many of these tax-exempt corporations, their special interest tax-exempt foundations, and their Washington-based lobbyists who will pursue an incredibly massive effort to retain their free ride under section 936, that I appear today.

I am here today in the spirit of our Nation's democratic process which, simply put, allows negotiation and compromise through the legislative process, including the deliberations of this committee on President Clinton's proposed changes to 936.

It is clear that President Clinton wants his economic package adopted without any changes, and support I him strongly. How-

ever, we must not lose sight of the fact that pursuant to the principle of no taxation without representation, the Federal Government has never collected income taxes in Puerto Rico. This will be the first time in our history that income taxes will be collected in Puerto Rico.

There is a misconception that there are no Federal taxes paid in Puerto Rico. There are. There are excise taxes, there are other taxes paid in Puerto Rico which amount to approximately $1.9 billion a year. We do pay Federal taxes, but not Federal income taxes from sources within Puerto Rico.

On March 2, I wrote to President Clinton setting forth several suggestions as to how 936 could be altered with a positive outcome for the local and the national economy as well. I called to the President's attention, as I call to your attention today, the need to enact amendments to 936 which will help accomplish our goals of Federal deficit reduction and, at the same time, put an end to the severe and untenable discrimination against the people of Puerto Rico in the health care program now known as Medicaid.

I want to underscore here that we are talking about health care, not welfare. Health care is different. Health care is an investment in the future, it is taking care of the children, it is taking care of widows, it is taking care of people who cannot afford to pay a doctor and have a health plan.

Puerto Rico is the only 100 percent Hispanic State-like jurisdiction in the Nation. At 3.6 million, our population is almost exactly equal to that of the average State, and our entire population of U.S. citizens is devoid of Medicaid coverage. We have more population than 26 States of the Union.

Can you imagine if there were any area in this country where there were 3.6 million African-Americans, U.S. citizens or 3.6 million Jews, U.S. citizens that were not treated equally under the health care program, can you imagine the uproar and the pressure and the request in this Congress and to the White House?

I would like to share the text of my letter to the President with you today, and I have attached a copy to the appendix of this statement. My letter to the President states as follows:

DEAR MR. PRESIDENT: Your State of the Union address has given hope and confidence to people from all walks of life throughout America. Our plan will give us a means to put our economic house in order and make sure that our children and their children will be able to live the American dream.

As you express in your message, these are good things for all. There is some pain, and we in Puerto Rico will be participating in both the benefits and the pain.

As part of your economic plan, the until now tax-exempt 936 companies will be subject to a tax credit limitation of 65 percent of their payroll.

Pursuant to your plan, Puerto Rico will for the first time be contributing to the Federal Treasury with revenue collected from income earned in Puerto Rico.

The U.S. citizens of Puerto Rico, for the first time, are being asked to share in the burden of putting this Nation's economy in order.

Mr. President, we cannot argue with the fairness of your proposal, but we can ask that you share with us our concern for the impact such a change could have in Puerto Rico and help to make sure that the changes you propose will create a new economic relationship that will be beneficial to Puerto Rico as well as for the rest of the Nation.

Allow me, therefore, to make the following suggestions so that you may not only move forward your plan, but also at the same time allow Puerto Rico room to adjust to the new conditions by providing more opportunity to create new jobs and thus meet with your objective.

(1) In the first place, the amendment of 936 limiting the tax credit should be revised and expanded from 65 percent to 100 percent of payroll, and also the time period of the phase-out to be increased from three to ten years. These changes maintain the basic incentive package you have proposed, but modify the extension of phase-in period and percentage applied to wage credit.

(2) For those corporations that are capital intensive rather than labor intensive, and whose payroll is low compared to their net income, I suggest that the Federal income allow an alternate investment tax credit for new corporations, which are building facilities and creating new jobs in Puerto Rico. For those corporations already established, the incentives would be subject to the creation of new jobs and building of new facilities. These alternate incentives would create new stimulus for investment and will stimulate growth.

The proposed amendment to section 936 has allowed vested interests to create an atmosphere of hysteria among the industrial sector, fostered by those individuals and corporations who refuse to contribute in any way to the solution of the Nation's problems and who resist any kind of change.

We fully understand the source of the hysteria, but we must face the reality that the widespread lack of understanding creates fear in the average citizen which in turn undermines the economic well-being of Puerto Rico.

There is fear that jobs may be lost and no alternatives are being offered to substitute the incentives we now have.

To calm these fears and to make sure that your plan is possible in every respect, that it is both good for the Nation and good for Puerto Rico, let me suggest that the Federal Government compensate Puerto Rico directly for the income tax burden that is being imposed on us for the first time in our history.

There are currently 3.6 million American citizens in Puerto Rico that are being deprived of the full benefits that Medicaid provides. This health safety net, on the U.S. mainland, is extended to all U.S. citizens. Aliens in the 50 States are also covered by Medicaid. At the same time, the U.S. citizens in Puerto Rico who would qualify because of their low income are denied this opportunity.

Mr. President, are you aware that even the veterans of Puerto Rico and their immediate relatives, those who gallantly served the Nation and the families of Puerto Rican soldiers who died in defense of our Nation are denied coverage under Medicaid?

Mr. President, is this fair?

In Puerto Rico we have a $79 million cap on Medicaid, and whenever we have asked for parity we have been told that we already have enough Federal assistance and that we are not going to get any more because we do not pay Federal income taxes. If Puerto Rico were granted parity in Medicaid, $1.2 billion would be available for health care. The availability in Medicaid coverage would not only have a substantial impact in the improvement of health standards in Puerto Rico but would also stimulate the creation of thousands of well-paying new jobs.

Some may allege that giving Puerto Rico parity in Medicaid will sap the new source of revenues being collected in order to help reduce the deficit. To this objection my answer is that it only takes a half of 1 percent adjustment in the present Medicaid payments to raise the $1 billion necessary for Puerto Rico.

Mr. President, if you endorse this proposal we can put to rest any fears in Puerto Rico, and you will be proposing a $1 billion stimulus to create new jobs, which is one of the principal goals of your program.

We are convinced it would be very difficult to oppose this plan, and I am certain we will have many friends in the House and Senate who will support us.

The rest of the letter does not go to the issue.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Secretary.

[The prepared statement and full text of the letter to the President follow:]

Hon. Carlos Romero-Barceló
Testimony before Ways and Means
10 AM Wednesday, March 17, 1993

Mr. Chairman, Members of the Ways and Means Committee:

I am here today as the sole elected representative in Congress of 3.6 million U.S. citizens in Puerto Rico. Six times the number of constituents represented by any other Congressman. I appear before you to address those provisions of President Clinton's deficit reduction and economic stimulus proposal that will impact on all 50 states and on Puerto Rico. Specifically, the proposed changes to Section 936 of the Internal Revenue Code will have a particular effect on Puerto Rico.

This Committee meets at a time when a climate of fear exists among many people in our island. A great deal of that fear has been stimulated and created by a group of federally tax-exempt corporations and their special interest tax exempt organizations, such as the Puerto Rico Manufacturers' Association, which would have our people believe that our economy and its development depend exclusively on Section 936. Have you noticed the full page advertisements by these corporations? If you believe them, you would think that the salvation and future of Puerto Rico hinges on not making any changes whatsoever to Section 936. In other words, that those corporations which now earn billions of tax-exempt dollars, be allowed their "free ride" forever, while the less affluent, hard-working middle class and low-income families are asked to share in the burden.

As some of you know, I am a former two-term Mayor of San Juan, and a former two-term Governor of Puerto Rico. In two decades of public service, never have I witnessed such a torrent of wild claims, distortions and exaggerations of the real impact of any proposed changes to the existing Section 936 of the IRC.

And you will undoubtedly hear more of them in the coming weeks and months. Let me give you an example of what I am talking about.

It is against this backdrop, against the fact that many of these tax exempt corporations, their special-interest tax-exempt foundations and their Washington-based lobbyists will pursue an incredibly massive effort to retain their "free ride" under Section 936, that I appear today.

I am here today in the spirit of our nation's democratic process which, simply put, allows negotiation and compromise throughout the legislative process, including the deliberations of this Committee on President Clinton's proposed changes to 936.

It is clear that President Clinton wants his economic

package adopted without any changes, and I support him strongly. However, we must not lose sight of the fact that pursuant to the principle of no taxation without representation, the federal government has never collected income taxes in Puerto Rico. This will be the first time in our history that income taxes will be collected in Puerto Rico.

On March 2, I wrote President Clinton setting forth several suggestions as to how 936 could be altered with a positive outcome for the local and national economy as well. I called to the President's attention, as I call to your attention today, the need to enact amendments to 936 which will help accomplish our goals of federal deficit reduction and, at the same time, put an end to the severe and untenable discrimination against the people of Puerto Rico in the health care program now known as Medicaid.

Puerto Rico is the only 100% Hispanic state-like jurisdiction in the nation. At 3.6 million, Puerto Rico's population is almost exactly equal to that of the average state. And our entire population of U.S. citizens is devoid of Medicaid coverage.

I would like to share the text of my letter to the President with you today, and am attaching it as an appendix to this statement.

To put it briefly, President Clinton's proposal would collect, for the first time in our history, corporate federal income taxes in Puerto Rico.

The President's proposal would end the 100% tax exemption of Section 936 companies. The 936 tax credit would be limited to 65% of payroll. The reasoning behind the President's proposal is valid and I have stated so publically, a very serious political risk in a very emotional climate back home.

However, in order to allow the economy of Puerto Rico time to adjust to the new conditions created by the amended tax incentives which are being established, I have made three suggestions. They are aimed at giving us room within which to adjust to a new economic relationship between Puerto Rico and the mainland. A fair relationship, with shared benefits and shared sacrifices.

First, I suggest that any amendment to 936 limiting the tax credit should be revised from 65% to 100% of payroll.

Second, the time period for the phase-in of the new wage tax credit should be extended from three years to ten years.

Third, an alternative investment tax credit should be allowed for corporations that are capital-intensive rather than labor-intensive. The investment tax credit would be available as an alternative to the wage tax credit to corporations which are

creating new jobs. Thus, corporations which are capital intensive and whose payroll is low in relation to its net income, could well prefer this alternative. This is an incentive that would create a real stimulus for investment and growth in the manufacturing sector.

But, not only do I submit that these changes are good and make the Administration's proposals easier to carry through, but I also have asked for a compensation to Puerto Rico. It would be unfair to impose income taxes on us without adequate compensation. And what could be adequate? Well, we have always been denied equal participation as American citizens in the health care program, in Medicaid. Based precisely on the fact that we do not pay federal income taxes. We are now going to pay substantial amounts, therefore we should now be given equal treatment, parity, in the health care program.

This means the removal of the existing cap on Medicaid. Now is the time to allow our medically indigent to have access to the same health care benefits available to U.S. citizens in all 50 states, the District of Columbia, and the access and benefits allowed to aliens residing in this country.

If Medicaid in Puerto Rico were given full funding, on an equal footing with the 50 states, the U.S. citizens of Puerto Rico who would qualify, including the veterans who have served the nation, would receive adequate coverage under the single most important program which exists to care for the medically indigent, which includes children, abandoned women, the handicapped and senior citizens.

In the past, whenever we asked, and we have asked repeatedly for equal treatment in Medicaid, we have been told that Puerto Rico doesn't pay federal income taxes. We have been told that Puerto Rico receives enough federal assistance. And those who have suffered have been the poorest among us, because of a $79 million cap on Medicaid funding.

As we change 936, now is the time to fully fund Medicaid in Puerto Rico.

Granting Puerto Rico parity in Medicaid means a billion-dollar injection into our health care system. Complete Medicaid coverage in Puerto Rico will create thousands of well-paying new jobs, and build a strong private health care system to raise our health standards.

The price of full funding of Medicaid in Puerto Rico is equivalent to a one and a half percent adjustment in the present Medicaid program. That's one option: to adjust the Medicaid budget by one and a half percent and that will suffice to include the medically indigent in Puerto Rico on an equal footing.

Members of this Committee, and in the Senate, have set forth

their own proposals to limit the 936 tax exemption. With due respect to all of them, no one has analyzed the 936 issue and the effect on Puerto Rico that amendments or change to the tax incentives would bring about, as I have. I am convinced that with equal treatment, parity, in Health Care and the changes I have proposed to President Clinton, the effect on Puerto Rico will be to stabilize the investment climate, strengthen the foundations of our economy, and provide thousands of new jobs in the private health care service sector.

At the same time, I have made it clear that we in Puerto Rico are prepared to share and contribute to the national effort which this Administration is launching to restore the economy. I will underscore again before this Congress the message that we will participate in the benefits and the burdens, both short and long-term, because both are part of the Administration package.

Among the benefits before us are the immediate stimulus in Community Development Block Grants, full funding for Head Start, boosting W-I-C, immunization, mass transportation funding, and doubling for this summer the Joint Training Partnership Act allocation for summer jobs. This is a stimulus at the local and national level. For the most part, Puerto Rico will benefit from the proposed stimulus for infrastructure, housing, and construction programs. However, Puerto Rico will not benefit from increased allocations in SSI and in earned income tax credits.

You will not hear expressions of support from 936 companies for these federal aid programs which pump millions of dollars into our local economy. In past years, we received no support from 936 companies in our repeated attempts to achieve equality in federal programs such as Medicaid.

Now, in a positive spirit of negotiation within the Administration and within this Committee, I have offered some suggestions to modify 936 in a manner beneficial to the national economy and to the people of Puerto Rico. Puerto Rico should not only be asked to contribute, but it should also receive compensation for its new burdens. There is no better compensation than equality in health care. We are not talking about welfare, but about health care. Investment in our childrens' and our people's health. Thank you.

CARLOS A. ROMERO BARCELÓ
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INSULAR AND INTERNATIONAL AFFAIRS

March 2, 1993

Hon. William Jefferson Clinton
President of The United States
The White House
Washington, D.C. 20500

COPY

Dear Mr. President:

Your State of the Union address has given hope and confidence to people from all walks of life throughout America. Your plan will give us the means to put our economic house in order, and make sure that our children and their children will be able to live the American dream.

As you expressed in your message there are good things for all and some pain, and we in Puerto Rico will be participating in both: the benefits and the pain.

As part of your economic plan, the until now tax-exempt (936) companies will be subject to a tax credit limitation of 65% of their payroll.

Pursuant to your plan, Puerto Rico will (for the first time) be contributing to the federal treasury with revenue collected from income earned in Puerto Rico.

The U.S. citizens of Puerto Rico, for the first time, are being asked to share in the burden of putting this nation's economy in order.

Mr. President, we cannot argue with the fairness of your proposal, but we can ask that you share with us our concern for the impact such a change could have in Puerto Rico, and help us make sure that the changes you propose will create a new economic relationship that will be beneficial to Puerto Rico as well as for the rest of the nation.

Allow me, therefore, to make the following suggestions so that you may not only move forward your plan, but also at the same time allow Puerto Rico room to adjust to the new conditions by providing more opportunity to create new jobs and thus meet with your objective.

1) In the first place the amendment of 936 limiting the tax credit could be revised and expanded from 65% to 100% of payroll, and also the time period for the phase-out should be increased from 3 to 10 years.

   These changes maintain the basic incentive package you have proposed, but modify the extension of phase-in period and percentage applied to wage credit.

2) For those corporations that are capital intensive rather than labor intensive, and whose payroll is low compared to their net income, I suggest that the federal government allow an alternate investment tax credit for new corporations, which are building facilities and creating new jobs in Puerto Rico. For those corporations already established, the incentives would be subject to the creation of new jobs and building of new facilities. These alternate incentives would create new stimulus for investment and would stimulate growth.

The proposed amendment to Section 936 has allowed vested interests to create an atmosphere of hysteria among the industrial sector, fostered by those individuals and corporations who refuse to contribute in any way to the solution of the nation's problems and who resist any kind of change.

We fully understand the source of the hysteria, but we must face the reality that the widespread lack of understanding creates fear in the average citizen, which in turn undermines the economic well-being of Puerto Rico.

There is a fear that jobs may be lost and no alternatives are being offered to substitute the incentives we now have.

To calm these fears and to make sure that your plan is positive in every respect, that it is both good for the Nation and good for Puerto Rico, let me suggest that the Federal Government compensate Puerto Rico directly for the income tax burden that is being imposed on us for the first time in our history.

There are currently 3.6 million American citizens in Puerto Rico that are being deprived of the full benefits that Medicaid provides. This health safety net, on the U.S. mainland, is extended to all U.S. citizens. Aliens in the 50 states are also covered by Medicaid. At the same time, the U.S. citizens of Puerto Rico who would qualify because of their low level of income are denied this opportunity.

Mr. President, are you aware that even the veterans of Puerto Rico and their immediate relatives, those who gallantly served the Nation, and the families of Puerto Rican soldiers who died in defense of our Nation, are denied coverage under Medicaid?

Mr. President, is this fair?

In Puerto Rico we have a $79 million cap on Medicaid, and whenever we have asked for parity, we have been told that we already have enough federal assistance and that we are not going to get any more because we do not pay federal income taxes. If Puerto Rico were granted parity in Medicaid, $1.2 billion dollars would be available for health care. The availability of Medicaid coverage would not only have a substantial impact in the improvement of health standards in Puerto Rico, but would also stimulate the creation of thousands of well-paying new jobs.

Some may allege that giving Puerto Rico parity in Medicaid will sap the new source of revenues being collected in order to help reduce the deficit. To this objection, my answer is that it only takes a half of one percent (0.05%) adjustment in the present Medicaid payments to providers to raise the $1 billion necessary for Puerto Rico.

Mr. President, if you endorse this proposal we can put to rest any fears in Puerto Rico and you would be proposing a $1 billion stimulus to create new jobs, which is one of the principal goals of your program.

We are convinced that it would be very difficult to oppose this plan. I am certain we will have many friends in the House and Senate who will support us. As your friend, as your fellow former Governor and your fellow Democrat, I am confident that with the implementation of this recommendation we can count on the enthusiastic support of the Democratic leadership.

But not only are the changes I have proposed to your plan good in terms of creating new jobs, but also you will personally be recognized as the President who has done justice to the hundreds of thousands of medically indigent in Puerto Rico who are now deprived of adequate health services. I'm sure that not only Puerto Ricans but all Hispanics, African-Americans and other minorities, will applaud and support your commitment to fairness and justice for all.

Our poor people, our men in the Armed Forces, our veterans who have served this nation and their families, will be grateful to you, William Jefferson Clinton, for the security and new sense of hope that your endorsement will represent to them and to their families.

Sincerely,

Carlos Romero Barceló

Carlos Romero-Barceló

STATEMENT OF HON. BALTASAR CORRADA DEL RIO, SECRETARY OF STATE OF THE COMMONWEALTH OF PUERTO RICO

Mr. CORRADA DEL RIO. Thank you, Mr. Chairman. My name is Baltasar Corrada. It was my privilege to serve in the House of Representatives for 8 years, beginning in 1977 as Resident Commissioner. Thereafter I was mayor of San Juan for 4 years.

Since January of this year, as Secretary of State, I have held the second highest office in the executive branch of the government of Puerto Rico. I appear today on behalf of the administration of our Governor, Dr. Pedro Rosselló. He is recovering from a health ailment and could not be here today.

Mr. Chairman, we fundamentally support the program that was outlined by President Clinton exactly one month ago. We believe that Puerto Rico, together with the rest of the Nation, will benefit from the implementation of that program. We are prepared to accept our full share of responsibility and, yes, the necessary sacrifices to ensure the success of this historic initiative. The burden of reform, however, must be shared equitably.

Five days before President Clinton's February 17th address, Governor Rosselló wrote a letter to the President. In that letter the Governor stated the following, and I quote:

> I know you will agree that no major class of Americans, and certainly not the 3.6 million American citizens who reside in Puerto Rico, should be singled out to bear a disproportionate share of the Nation's burden.

Mr. Chairman, I regret to report that in its current form the President's plan does impose a disproportionate burden upon the people of Puerto Rico. As members of this committee are well aware, Puerto Rico's apprehension arises from a proposal pertaining to section 936 of the IRC.

Section 936 grants a tax credit to encourage American businesses to establish subsidiaries in Puerto Rico and other U.S. territories. The chairman of the Senate Finance Committee, Senator Moynihan, has described it in this way, and I quote:

> Section 936 is part of the arrangements we offer for economic development in possessions of the United States. It is their due. They do not have many rights as possessions, as it were.

To what was Senator Moynihan referring? To many things. Among others, the absence of voting representation in the United States House and Senate, disenfranchisement in Presidential elections, ineligibility for full funding under numerous Federal programs, and exceptionally high shipping expenses resulting from a congressionally imposed requirement that all ocean cargo to and from the mainland be transported by American flag vessels.

At present about 115,000 Puerto Ricans who are residents of the island are working for companies that operate under section 936. That constitutes more than 70 percent of the island's total manufacturing payroll. Also, it is estimated that these firms generate about 200,000 indirect jobs. Furthermore, the insular government receives approximately 15 percent of its total revenue, approximately $600 million annually, from local taxes paid by 936 enterprises.

The cost of borrowing money in Puerto Rico would be substantially higher than it is if our financial institutions did not hold in excess of $10 billion in earnings deposited by these firms. And stability throughout the Caribbean basin has been placed on a firmer footing in recent years thanks to a directive by Congress that 100 million of those section 936 dollars be channeled annually into regional lending for economic development.

With respect to this last point, it is noteworthy to say that President Clinton is on record as objecting to legislation that encourages American enterprises to set up shop elsewhere. The Rosselló administration sympathizes with that sentiment.

As it pertains to Caribbean basin lending, though, we would offer these observations: First, illegal immigration and drug smuggling from the Caribbean area have escalated severely during the past decade. One indispensable remedy for both problems is the creation of productive jobs in the region. That is precisely what section 936 loans are accomplishing.

Second, we in Puerto Rico would support legislation to authorize the use of this substantial pool of moneys for the financing of similar job-creating ventures within depressed portions of the 50 States, as yet another tool to help ensure the success of the Clinton recovery program.

In light of these observations, it would therefore be a great mistake to contemplate modifications of section 936, if such steps had the abrupt effect of eroding or eliminating the section's so-called passive income provisions. It is likewise imperative that the utmost caution be exercised in considering any other modification of section 936. No one would ultimately profit from the arbitrary crippling of Puerto Rico's capacity to become more self-sufficient. And speaking of our drive for greater self-sufficiency, Governor Rosselló was elected last November on a platform that clearly articulated the need to implement a broader and more balanced economic development strategy.

For instance, one of the key goals of our economic program is to double, from 6 to 12 percent, the tourism industry's contribution to our gross product. Let us now turn to the central question. If section 936 is to undergo major change, what could adequately replace some of its provisions? Our administration is preparing to consider and to support a package of equitable alternatives.

These would encompass both job creation and capital investment tax credits. If properly structured, they could promote President Clinton's national agenda, while fully satisfying the economic development aspirations of the American citizens in Puerto Rico.

The incorporation of a variety of balanced elements would constitute a special enterprise zone for Puerto Rico. This concept would have unquestionable merit and be entirely justified because we would in the process be modifying an incentive that now provides for total Federal tax exemption. Accordingly, incentives for Puerto Rico must be made attractive enough to maintain or improve our ability to attract capital investment and to promote the creation of more jobs.

We are convinced, Mr. Chairman, that the Clinton administration's 65 percent wage credit formula is not the answer. It needs to be enhanced. With your assistance and the assistance of mem-

bers of this committee and that of the White House, the island and the Nation can be spared these costly hardships, for example, among other things, by improvements in the wage credit proposal, as was suggested by the Resident Commissioner, by the inclusion of tax credits for new investment, and by the preservation of the existing treatment of passive income.

As I have indicated, you can count on Governor Rosselló's total cooperation. Together we can arrive at a solution that is fair and that is in harmony with the President's commendable national program. Thank you very much, Mr. Chairman, and members of the committee.

[The prepared statement follows:]

Testimony of

The Honorable Baltasar Corrada

Secretary of State

Puerto Rico

Mister Chairman, members of the Committee on Ways and Means... From an island that is green throughout the year, I bring warm greetings to all, on this Saint Patrick's Day!

My name is Baltasar Corrada. It was my privilege to serve in the House of Representatives for eight years, beginning in 1977, as Resident Commissioner from Puerto Rico. Thereafter, I was Mayor of San Juan for four years. Since January of this year, as Secretary of State, I have held the second highest office in the executive branch of the Government of Puerto Rico.

I appear today on behalf of the administration of the Governor of Puerto Rico, Doctor Pedro Rosselló.

Mister Chairman and members of this committee, we fundamentally support the program that was outlined by President Clinton, exactly one month ago tonight.

We believe that Puerto Rico, together with the rest of the nation, will benefit from the implementation of that program. We are prepared to accept our full share of responsibility and -- yes -- the necessary sacrifices, to ensure the success of this historic initiative.

The burden of reform, however, must be shared equitably.

Five days before Mr. Clinton's February 17th address, Governor Rosselló wrote a letter to the President. In that letter, the Governor stated the following -- and I quote: "I know you will agree that no major class of Americans -- and certainly not the 3.6-million American citizens who reside in Puerto Rico -- should be singled out to bear a disproportionate share of the nation's burden."

Mister Chairman, I regret to report that -- in its current form -- the President's plan does impose a disproportionate burden upon the people of Puerto Rico.

More than four weeks ago, Governor Rosselló directed members of his cabinet to quantify this concern. He also instructed those officials to collaborate with the federal Department of the Treasury and with the General Accounting Office, which have been conducting their own analyses of the situation. We hope very soon to present our findings to the President himself.

As members of this Committee are well aware, Puerto Rico's apprehension arises from a proposal pertaining to Section 936 of the Internal Revenue Code.

Section 936 grants a tax credit, to encourage American business enterprises to establish subsidiaries in Puerto Rico and other United States territories. The Chairman of the Senate Finance Committee, the Honorable Daniel Patrick Moynihan, has described it this way -- and, again, I quote: "Section 936 is part of the arrangements we offer for economic development in possessions of the United States. It is their due. They do not have many rights as possessions, as it were."

To what was Senator Moynihan referring? To many things...among them, the absence of voting representation in the United States House and Senate; disenfranchisement in Presidential elections; ineligibility for full funding under numerous federal programs; and exceptionally high shipping expenses, resulting from a Congressionally-imposed requirement that all ocean cargo, to and from the mainland, be transported by American-flag vessels.

Puerto Rico, moreover, confronts additional challenges: no revenue from mining or oil-drilling; a population density that is 15 times the national average; a per-capita income that, despite substantial gains, is still only one-third the national average; and an unemployment rate of 17-percent.

At present, about 115-thousand Puerto Rico residents are working for companies that operate under Section 936. That constitutes more than 70-percent of the island's total manufacturing payroll. Also, it is estimated that these firms generate about 200-thousand indirect jobs. Furthermore, the insular government receives approximately 15-percent of its total revenue -- approximately 600-million dollars annually -- from

local taxes paid by 936 enterprises.

The cost of borrowing money, in Puerto Rico, would be substantially higher than it is, if our financial institutions did not hold in excess of ten-billion dollars in earnings deposited by 936 firms.

And stability, throughout the Caribbean Basin, has been placed on a firmer footing in recent years, thanks to a directive by Congress that 100-million of those Section-936 dollars be channeled annually into regional development lending.

With respect to this last point, it is noteworthy that President Clinton is on record as objecting to legislation that encourages American enterprises to set up shop elsewhere.

The Rosselló Administration sympathizes with that sentiment. As it pertains to Caribbean Basin lending, though, we would offer these observations:

First, illegal immigration and drug-smuggling from the Caribbean area have escalated severely during the past decade; one indispensable remedy for both problems is the creation of productive jobs in the region. That is precisely what Section 936 loans are accomplishing.

Second, we in Puerto Rico would support legislation to authorize the use of this substantial pool of monies for the financing of similar job-creating ventures within depressed portions of the 50 states...as yet another tool to help ensure the success of the Clinton recovery program.

The resources are available to proceed on both of these fronts, simultaneously.

In light of the above observations, it would therefore be a great mistake to contemplate modifications of Section 936, if such steps had the abrupt effect of eroding or eliminating the section's so-called "passive income" provisions...because it is those very provisions that have created this abundant source of constructive low-interest lending.

It is likewise imperative that the utmost caution be exercised in considering any other modification of Section 936. <u>No one would ultimately profit from the arbitrary crippling of Puerto Rico's capacity to become more self-sufficient.</u>

And speaking of our drive for greater self-sufficiency, Governor Rosselló was elected last November on a platform that clearly articulated the need to implement a broader, and more balanced, economic development strategy. Our Administration has already taken steps both to stimulate the expansion of sectors of the economy other than manufacturing, and also to diminish Puerto Rico's dependence upon tax incentives as an employment-stimulus.

For instance, one of the key goals of our economic program is to double, from six-percent to twelve-percent, the tourism industry's contribution to our gross product. Coupled with its impact on other sectors of the economy, we anticipate that tourism will significantly expand employment opportunities and thereby help Puerto Rico to achieved more-balanced growth.

Other aspects of our economic plan envision the accelerated promotion of the export of goods and services, to the countries of Latin American and the Caribbean, as well as moves at home to take our government out of economic activities that could more efficiently be entrusted to the private sector.

Let us turn now to a central question: if Section 936 <u>is</u> to undergo major change, what could adequately replace some of its provisions?

Our Administration is preparing to consider, and to support, a package of equitable alternatives.

Among the components of such a package, in addition to the preservation of passive income provisions, could be the enactment of an enhanced array of enterprise zone incentives.

These would encompass both job-creation and capital-investment tax credits. If properly structured, they could promote President Clinton's national agenda, while fully satisfying the economic development aspirations of the American citizens of Puerto Rico.

The incorporation of a variety of elements into such a special enterprise zone concept would have unquestionable merit,

and be entirely justified, because we would in the process be relinquishing an incentive that provides total federal tax exemption. Accordingly, special enterprise zone incentives must be made attractive enough to maintain or improve our ability to promote the creation of quality jobs.

We are convinced, Mister Chairman, that the Clinton Administration's 65% wage-credit formula is not the answer. If implemented...

- It would fall far short of its revenue target.
- It would greatly weaken the economy of Puerto Rico, and have an immediate ripple effect throughout the 50 states -- which, each year, sell to the island some 11-billion dollars in goods and services.
- It would increase budgetary pressures on mainland states, counties and municipalities -- as well as on the federal government -- through a sharp upsurge in the number of Puerto Ricans moving north, in search of opportunities lost at home.

With your assistance, and that of the White House, the island and the nation can be spared these costly hardships...for example, among other things, by improvements in the wage-credit proposal; by the inclusion of tax credits for new investment; and by preservation of the existing treatment of passive income.

As I have indicated, you can count on Governor Rosselló's total cooperation. Together, we can arrive at a solution that is fair, and that is in harmony with the President's commendable national program.

Thank you very much.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. Could the Chair get an indication if the membership would like to question the witnesses?

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Welcome both of my friends once again to the Ways and Means Committee, different titles, different positions, but we are back here. Please express my wishes to the Governor for his speedy recovery. As both of you know well, the 936 programs have been attacked as being extremely expensive in terms of job creation.

The pharmaceutical companies have been charged with receiving obscene profits, the consumers of prescription goods have found the price ever increasing, and yet both of you at one time or another when you were defending the program have said that whether you have 936 or not, the most important thing, are not the companies but the people in Puerto Rico, and that if indeed this is not the proper way to go or it is too expensive, then really what you should have is a substitute for it to make certain that the economy and the people and the families are not adversely affected.

It seems as though both of you are basically saying the same thing and it is just a question of time. You, Congressman, seem to believe that you can strike and negotiate a different position from the administration by incorporating a give-back for expansion of Medicaid. I would just like to say for the record, yes, it is outrageous that our citizens would be treated differently, and I don't want to get involved as to whether this is the proper vehicle, but you can count on my support for your continuous fight to have all Americans, wherever they are located, to be treated equally.

Having said that as it relates to what you are trying to get from the administration, what is your position if the administration doesn't change its position, if it just comes in with the proposal that it has and tells the Congress and this committee that we would prefer that you just do what we requested of you and not modify it? Would you be supporting the 936 program as it presently exists or would you be inclined to support the President's program without modification?

Mr. ROMERO-BARCELÓ. Let me answer that, Mr. Rangel, with an incident that happened in my office. I was visited by a company that came to try to convince me to support the 936 as it is and not to go along with the President's proposal. They started telling me that because of the President's proposal they would have to start looking at their new investments and maybe they would not be inclined to stay in Puerto Rico. They didn't know yet, but they certainly would have to change their investment strategy. It could mean they were not going to make any new investments. It could mean they would end up not having any investments in Puerto Rico and leaving Puerto Rico.

Mr. RANGEL. Congressman, you are going to be listening to more people than me, and I am going to rely heavily on you after you have heard all of them and you have heard more than I ever hoped to hear from. Would you be inclined to say if the President insisted on his position, and I am not asking you to give up yours, in terms of giving your guidance to this committee without making a firm

commitment, are you more inclined to the present program or to the President's recommendation?

Mr. ROMERO-BARCELÓ. I think that it would be making it very difficult to separate one thing from the other.

Mr. RANGEL. I withdraw my question. I don't want to make it difficult for you. I don't see how it can get more difficult for me.

Mr. ROMERO-BARCELÓ. Let me explain why I say that. Every time we have come to be treated equally as a State in health care, they have always said you don't pay income taxes. That has been the answer. Now, this is going to be the first time in our history where income taxes are going to be collected from sources within Puerto Rico, the first time. So I said now you are going to be collecting $7 billion in the next five years according to the White House figures, and $8 billion according to the Congress figures.

Now, give us something in exchange for that. We are going to be sharing in the burden of reducing the deficit, but now we are not going to receive the earned income tax credit.

Mr. RANGEL. I understand your argument, and I really think that the Secretary of State in part is saying, even though he wants a longer period, that he hopes, too, that there could be some transition away from 936 to some substitute. I don't have that time. All I am concerned about is that the economy of Puerto Rico not be disrupted.

Now, in the past when you were Governor and you were a Congressman what we were saying is not what you do want, but have hearings and give some assurances that whatever is decided by the United States Congress that we will not have the fear of loss of jobs which you talk about, but actual loss of jobs. I am not certain as to whether or not if there was a Medicaid expansion substitute whether there would be an expansion in the number of jobs, but what I am concerned about is that we haven't had hearings on this, and I am not going to second guess elected officials in Puerto Rico, but obviously you believe that there will not be an impact if your package was accepted by the President.

Mr. ROMERO-BARCELÓ. That is correct.

Mr. RANGEL. And at this time you have no opinion as to what your position would be if your package is rejected by the administration.

Mr. ROMERO-BARCELÓ. That is correct.

Mr. RANGEL. Now, to the Secretary of State——

Mr. ROMERO-BARCELÓ. I have an opinion, but I would rather not express it in public.

Mr. RANGEL. OK, that is all right. To the Secretary of State, I assume a lot of the administration's position as to whether 936 is good or bad is driven by whether or not people want statehood or commonwealth or ultimately what form of government the majority people want; is that correct?

Mr. CORRADA DEL RIO. I think we have to look at this as a tax policy and not an ideological political status issue. I think that we should craft a system of tax incentives for Puerto Rico by this committee concerning President Clinton's proposal and enhancement of that proposal, and then if we have statehood, then those provisions can be grandfathered for a period of transition. If the people of Puerto Rico decide that they want to keep the current arrange-

ment, then it could be consistent with that, too. In other words, the changes to section 936 should be status neutral. They should not be an impediment to statehood and they should not be support for commonwealth.

Mr. RANGEL. OK. Now, do you believe that the expansion of Medicaid as suggested by the Congressman would be a substitute for the loss of the 936 exemption?

Mr. CORRADA DEL RIO. No, Mr. Congressman. What I suggest, and it is Governor Rosselló's position, is that within the context of the health care reform package that this issue of Medicaid and the cap on Medicaid for Puerto Rico should be addressed, and it is with respect to that proposal that we should be looking at fairness toward Puerto Rico in Medicaid and the suggestion of the Resident Commissioner concerning a mild increase in Medicaid taxes to include Puerto Rico as part of the Medicaid program certainly is a step in the right direction.

Mr. RANGEL. Mr. Chairman, I would just like to strongly suggest that if it is at all possible for you to get together and see whether you can get any closer on this issue because a whole lot can drop between the cracks if we have this very sharp disagreement.

Chairman ROSTENKOWSKI. Mr. Reynolds will inquire.

Mr. CORRADA DEL RIO. We are much more closer today than before.

Mr. REYNOLDS. Thank you, Mr. Chairman. I want to continue in the same vein. I think it is important. I am concerned about the exemption and the whole ramification of jobs, and I would like to be informed more—I am new, as you are, Congressman—about this exemption in the sense if we take it away are we hurting the people of Puerto Rico. I have a family interest, a vested personal interest in this, and I would like to know are we going to hurt the people of Puerto Rico if we take this exemption away.

Mr. ROMERO-BARCELÓ. Let me give you the example I was talking about a little while ago. The company that came to see me was the largest employer in Puerto Rico in 936. They have 6,000 jobs. When they start telling me that they have to revise their strategy, I said wait a minute, don't talk about what you are going to do without giving me facts. Give me facts. I said, what is your—how many employees do you have. They said 6,000 in Puerto Rico. What is your net income? The net income was $287 million. I said OK, $287 million at 36 percent of the corporate tax, which is what it is going to be under Clinton's proposal to increase such tax rate, that would be $103 million in taxes that you will be liable for in any State of the Union.

Now, in Puerto Rico you are being offered a tax credit, a wage tax credit of 65 percent of payroll. What was your payroll? $115 million, so 65 percent of $115 million is $74 million, so that means your tax liability is not going to be $103 million in Puerto Rico, it would be $103 million minus $74 million, which would amount to $28 million. Now, do you really mean to say that a tax liability of $28 million out of $103 million would not be an incentive to stay and expand in Puerto Rico?

His reaction was to look at the guy that was with him and say, "are those the right numbers?" It tells me that as long as the companies—for instance, net income is two and a half times the payroll

or less, the wage credit is very good. When it gets beyond two and a half times the payroll, that is when then the incentive or credit begins to lose attractiveness.

Mr. REYNOLDS. Briefly what is the position of the current Governor as relates to this issue?

Mr. CORRADA DEL RIO. The position of Governor Rosselló is that changes to 936 have to be addressed by the administration and by this committee with caution. If the President's proposal can be enhanced in the right way along the lines that we have suggested, both the Resident Commissioner and I in our testimony, then I think that most of these companies will stay in Puerto Rico. However, if there is a drastic reduction of this program without providing enhancement to the present proposals, there could be further exacerbation of the 17 percent level of unemployment we currently have on the island.

Mr. REYNOLDS. Thank you very much.

Mr. RANGEL [presiding]. Well, with the Chair not here we can get back to where we were earlier. Listen, what is very important in this process is that the full committee not understand all of the problems, but understand how close the government representatives are to the administration. Most of the Members of Congress really don't want to decide what is best for Puerto Rico, you can understand that.

Could you share with me, Congressman, the progress that you have made with your proposal, your alternative to the President's proposal.

Mr. ROMERO-BARCELÓ. I am sorry?

Mr. RANGEL. The progress you have made either with Treasury or——

Mr. ROMERO-BARCELÓ. Yes, I have spoken at length to Mrs. Clinton where she received our proposal and she was very interested. She felt very impressed by the fact that Puerto Ricans were not covered under the health care, and she said she was going to look very much into it very seriously. I got a letter from her indicating they were looking at it. I spoke to Mack McLarty. He was also very impressed and very interested in my proposal. He also sent me a letter saying they were looking at it very closely. The same, Howard Paster, I spoke to him, and he was also very impressed.

Mr. RANGEL. Do you have a timeframe that they are going to get back to you and let you know whether or not they are going to change their positions so that we can know what to do here?

Mr. ROMERO-BARCELÓ. No, I don't have a timeframe, but I would assume by May, when they have the health care reform package, that we should know because we will know whether Puerto Rico is included in that. The President, last night we were over in the White House, and he indicated that they were looking at it within the context of the whole health care reform. Leon Panetta indicated the same thing to me this morning.

Mr. RANGEL. Now, to the Secretary of State, recognizing that the Resident Commissioner has an alternative to the President's proposal as relates to 936, what vehicle is being used by the Governor of Puerto Rico to share the position that has been given to this committee with the administration?

Mr. CORRADA DEL RIO. Governor Rosselló, through a task force that he has appointed, of which I am a member, has been active in having meetings with key members of the White House and the U.S. Treasury Department. Currently, meetings are being held between the technical people, and once the technical proposal has been evaluated by the White House and the U.S. Treasury technical people, it is expected that the Governor himself will have a meeting with the President to discuss these provisions, and we are trying to persuade the administration to enhance and improve President Clinton's proposal.

We have not given up yet but rather will continue very strong efforts to see if the President's proposal can be modified by the administration itself and then present that to the Ways and Means Committee. Should we not be successful in doing that, then, Mr. Congressman, of course, we will exercise our full prerogatives in the democracy to come to the Ways and Means Committee, to go to the Senate Finance Committee in identifying those areas where we believe that enhancement can be and should be achieved, but right now we are hopeful. We have put on the table a proposal that still would yield significant amounts to the Federal Treasury in revenues within the next 5 years, and at the same time we believe would not create an adverse impact on the job situation in Puerto Rico.

Mr. RANGEL. And you believe the process is flexible enough for the Resident Commissioner to have one position and the Governor to have another position, and then we will decide here as to what is the best position?

Mr. CORRADA DEL RIO. Mr. Congressman, the Resident Commissioner and I have met. I have fully disclosed to him the options that are being discussed with Treasury and the White House, and it is our hope that as this process continues that the position of Governor Rosselló and Resident Commissioner Romero will not be significantly different.

Mr. RANGEL. Could you share, in case I have missed it, where it is that you two right now are in accord, where you have no problem at all?

Mr. ROMERO-BARCELÓ. Do you want me to answer that?

Mr. RANGEL. I don't care.

Mr. ROMERO-BARCELÓ. I think we are in accord in the sense that the present proposal as to the 65 percent of payroll should be reviewed and extended instead of 65 up to 100 percent wage tax credit, which would cover most companies up to net income three times the payroll, and I think we will be very much—we will be in agreement in the sense that we need some kind of compensation for the income taxes that are going to be collected from within Puerto Rico, and I think that Medicaid is—or health care is the one substantial area where this is most important.

I think that there should be—at the end there will be no differences in that, in that respect.

Mr. RANGEL. I have to go vote, but Mr. Payne will be taking over.

Mr. CORRADA DEL RIO. We have both talked about the need for investment tax credit for new investments as well.

Mr. PAYNE [presiding]. I would like also to thank you both for being here. Thank you for your testimony. I found it very helpful.

I had several questions. Maybe I will submit some of these for the record, but let me just start on this list.

First, for my colleague the Resident Commissioner, Carlos, you have favored statehood and have been a very fierce advocate of statehood in the cause for many years. If the changes that are proposed to section 936 have an adverse effect on Puerto Rico's economy, there are some who say that it may be more difficult for Puerto Rico to become a State as the economic disparity between the U.S. mainland and the island becomes perhaps even greater. How would you respond to that and are you and others who are advocates of Statehood, are you concerned about that?

Mr. ROMERO-BARCELÓ. We would be concerned if there was any adverse impact. I think that if what we are proposing is accepted, there will not be any adverse impacts. I am representing, and I am interested in the welfare of the people of Puerto Rico. I would certainly not accept, or say that I accepted, anything that I thought would be harmful to the interests of the people of Puerto Rico in the short run or in the long run. I don't see this as anything that we have to fear. They are changes that if done properly, and within the information and data that we have, will not affect Puerto Rico if what we are proposing is accepted. We are pretty confident of that. I think for instance of how a boost to the commercial health care in Puerto Rico would provide thousands of new jobs. It would strengthen our health care network and the private health care industry in Puerto Rico. An enhanced health care network would probably generate in Puerto Rico the stimulus for becoming a center for health care services in the Caribbean and Central America, which would additionally expand jobs and actually would amount to exporting services. It will be very, very healthy for the Puerto Rican economy.

Mr. PAYNE. So you are saying that in the absence or if section 936 is changed, but yet if your proposals are accepted, then you see no adverse impact? In the event that section 936 should be changed and your proposals are not accepted——

Mr. ROMERO-BARCELÓ. There might be some impacts, yes.

Mr. PAYNE. So then you would be concerned, perhaps, about the impact and consequently perhaps about the impact on Statehood; is that correct?

Mr. ROMERO-BARCELÓ. There would be some impact to Statehood, of course, if the economy of Puerto Rico gets worse, as you say, and the difference between Puerto Rico and the poorest State of the Union is expanded because of that, has always been used as an argument against us in statehood, and has been used as an argument against all the territories as they try to become a State. That is one of the arguments that was always used against them also.

Mr. PAYNE. Mr. Secretary, there was an article in Sunday's New York Times describing the operations of U.S. companies in Puerto Rico and how they benefit from section 936, and in that article a securities analyst from Paine Webber predicted that in the pharmaceutical industry that companies currently operating in Puerto Rico, I think he said they would leave if there were significant changes to 936, but certainly they might leave. I guess my question is if pharmaceutical companies left Puerto Rico and relocated to,

say, Thailand or Ireland or somewhere else in the world, how would this affect Puerto Rico's economy?

Mr. CORRADA DEL RIO. Mr. Congressman, I think that is a good question, and I would say this, pharmaceutical companies which are 936 companies have created only 18 percent of the total number of jobs, direct jobs that are created by section 936 companies in Puerto Rico. Out of 105,000 direct jobs created by section 936, the pharmaceuticals have created only 18,000 of those jobs. However, they are very well-paying jobs, and many of these companies are, of course, having very significant profits.

I believe that if changes are made to President Clinton's proposals along the lines that both Resident Commissioner Romero-Barceló and Governor Rosselló are proposing that the vast majority of these companies will not leave the island. Furthermore, I think that the Ways and Means Committee should look into closing loopholes that would not allow these companies to run away from Puerto Rico and go to foreign countries and perhaps some provisions could be included in your proposals precisely to prevent that from happening, companies shutting down their operations in Puerto Rico and going to Singapore or elsewhere in the world.

Mr. ROMERO-BARCELÓ. There is no reason, Congressman, Mr. Chairman, for the pharmaceuticals to move for several reasons. I don't know if you have ever visited a pharmaceutical, but there are some areas which are especially protected from the environment, and that takes a long time to set up and it takes a lot of supervision by the Food and Drug Administration. It is not easy to set up those kind of plants and it is not easy to move them. The investment is quite large, and the productivity and the quality controls that are already established in Puerto Rico are factors that have to be considered. Puerto Rico has very, very high quality controls in the pharmaceutical industry and the workers are very, very productive, and we are within the United States, protected by the American flag and the U.S. judicial system. It is not easy for a company to make a decision to move and to make pharmaceutical products in a foreign country. It is not that easy.

It is a very difficult decision to make, particularly when they are making such large profits in Puerto Rico. I have never known of investors who are making large profits, who decide to relocate just because they have to pay some taxes. It is when their profits start coming down and when they are no longer having profits that they start thinking of moving, but it would be a very, unreasonable, an almost stupid decision, to move from an area where you are making very, very good profits, and where you have a good highly productive work force and excellent quality controls. It is not as easy as they say.

Mr. PAYNE. It is my understanding that we will have some of those pharmaceutical companies here for hearings, and we can talk to them about these issues as well.

I have some other questions which I would like to submit for the record if there is no objection.

Without objection, so ordered, and Mr. Secretary, I would appreciate it if you might then answer some of these other questions relating to how 936 changes might affect Puerto Rico's economy. Thank you very much.

[The questions and responses follow:]

QUESTIONS ON SECTION 936 FROM CONGRESSMAN LEWIS F. PAYNE, JR. REPRESENTATIVE OF THE STATE OF VIRGINIA, TO SECRETARY OF THE STATE OF PUERTO RICO, MR. BALTAZAR CORRADA DEL RIO

1. All the wage credit proposals or caps on Section 936 incentives that have been presented would significantly reduce the incentives for all capital-intensive industries to invest in Puerto Rico. Some of these capital-intensive industries have already indicated that if the incentives are so reduced they would eventually phase out their operations in Puerto Rico. What would the Commonwealth of Puerto Rico do to replace the thousands of high-wage jobs generated directly and indirectly by these companies, particularly in light of the fact that many labor-intensive industries will be encouraged to move to Mexico under the NAFTA?

   Answer:

   On April 27, Governor Pedro Roselló presented - as an alternative to President Clinton's plan - his own proposal for modifying Internal Revenue Code Section 936. The Roselló alternative envisions limiting some of the Section's benefits, but does not contemplate its outright repeal. Under the Governor's proposal, incentives for high-technology and capital-intensive enterprises would be retained, through an income-based credit that would be reduced next year 90% to of its current level, and then to 80% of its current level in 1985 and beyond. This approach ameliorates the adverse impact of the President's plan.

   For their part, labor-intensive Section 936 firms would have the option of choosing a tax credit equal to the sum of the following:

   1. The total compensation paid to the employees.

   2. All income taxes paid to the Island, including the Tollgate Tax.

   3. Federal income taxes attributable to qualified possessions source investment income (QPSII).

   4. 10% of new capital investment in plant, machinery and equipment.

By offering incentives that will preserve for labor-intensive manufacturers a comparative advantage over other localities, this alternative reduces the likelihood of an exodus of operations from Puerto Rico, even after implementation of the terms of the North American Free Trade Agreement (NAFTA). Nevertheless, Puerto Rico's Economic Development Administration will intensify its efforts to promote the establishment of labor-intensive locally-financed industries and other forms of capital investment, as well as new domestic and international markets for insular goods and services.

2. The passive source income provision of Section 936 encourages bank funds to remain available for lending in Puerto Rico at lower rates. If the proposed changes to Section 936 reduce the available funds in the financial sector in Puerto Rico, what effects would a 2 percentage point increase in mortgage loans have on Puerto Rico's construction and real estate industries?

Answer:

Section 936 funds, deposited in the Island's financial institutions, certainly do contribute to the stimulation of economic activity, through low-cost financing for residential development, construction, and real-estate ventures, among others. A rise in loan interest rates definitely has the efect of making it more expensive to obtain financing, and thereby tends to shrink the market. A dramatic change, such as the President's proposed elimination of Section 936, could result in the withdrawal of some bank deposits, and in the process would probably nullify the 936 pool's capacity to serve as a tool for generating local economic activity. However, Governor Rosselló's alternative would retain a Section 936 tax credit for all the qualified possessions source investment income of the 936 companies, as well as the existing method for utilizing funds deposited in local institutions. Thus, it can safely be said - without the need for specific quantification - that implementation of the Rosselló alternative would have little if any negative impact. If the other components of the Section 936 provisions remain as is, there will be no reason to anticipate any diminution in the availability of funds for low-cost lending. We do not rule out the possibility of a reasonable adjustment, but we believe it would have only a marginal impact.

For additional information, we are enclosing herein a comprehensive report on the use of 936 funds prepared by the Government Development Bank for Puerto Rico.

3. Mr. Corrada, 936 funds have also provided a vital source of funds for loans from entities like the Inter-American Development Bank. These Caribbean nations have already voiced strong concerns about the impact of NAFTA on their economies. If 936 funds are limited so as to reduce the loans for the Caribbean nations, it is very likely that these Caribbean economies will suffer as well. Have you studied what impact this will have on Puerto Rico's own economy, since Puerto Rico benefits when there is increased prosperity in the Caribbean? Also, what alternative to the loans could we offer to the Caribbean nations?

Answer:

Section 936 funds have certainly served as a driving force for Caribbean development, through their utilization as a low-cost source of financing, both on the Island and regionally. Also, we cannot dismiss the possibility that the implementation of NAFTA will have the effect of luring certain economic activity away from the area, and that includes Puerto Rico. However, existing studies of the situation are insufficiently exhaustive to suggest - other than in a highly speculative maner what the effects of such an accord might be. Were significant displacement to occur, coupled with enactment of the President's Program calling for the substantial elimination of Section 936 benefits, then the consequences would include not only economic contraction within the countries of the region, but a slowdown in commercial interchange with countries outside the affected zone, given the inter dependence of the economies of the North American Hemisphere. Specifically, any changes that have the effect of possibly restricting or eliminating the use of Section 936 monies to stimulate Caribbean economic activity will inevitably diminish the availability of loans, thereby reducing growth opportunities is developing countries. A reduction in this financing source would, in other words, weaken Caribbean economic activity and diminish the area's capability as both an exporter and an importter.

Governor Roselló's Proposal, though, contemplates no halt to the used of Section 936 funds for investment in Caribbean Basin development projects. There might, however, be a need to adjust priorities, since modifications in the Section's provisions could alter to some extent the availability of money for such lending. Alternative sources of funding would then be required through other ageencies such as OPIC, the Inter-American Development Bank, and other U: S: and to the region.

We are enclosing herein a recent list of CBI loans.

4. Concern has been expressed by bond market specialist that the credit worthiness of Puerto Rican bonds would be severely reduced or damaged with the result that borrowing costs for infrastructure development in Puerto Rico would become prohibitive. What provision has been made for this eventuality?

<u>Aswer</u>:

Governor Roselló's Alternative Proposal provides for a minimal revision of Section 936, in marked contrast to the President's Plan. This distinction should serve to demonstrate to bond market specialists that Puerto Rico is fully prepared to contribute its proportionate share toward resolving the difficult situation that confronts the Nation, but with a commitment to maintain a reasonable margin for stability regarding economic conditions on the Island. It is this stability that in the past has been the cornerstone of the bond market's confidence in the operations of the Government of Puerto Rico.

[THE COMPREHENSIVE REPORT ON THE USE OF 936 FUNDS PREPARED BY THE GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO THAT WAS MENTIONED IN THE RESPONSE TO QUESTION 2, IS BEING RETAINED IN THE COMMITTEE FILES.]

TESTIMONY BY

The Honorable Pedro Rosselló

GOVERNOR OF PUERTO RICO

Delivered before the COMMITTEE ON FINANCE
UNITED STATES SENATE

Washington, D.C.
April 27, 1993

Mister Chairman, distinguished members of the Committee on Finance:

My name is Pedro Rosselló. I am the Governor of Puerto Rico. I welcome this opportunity to testify regarding changes, proposed by the Administration, to Section 936 of the Internal Revenue Code.

A letter from President Clinton was read aloud at my inauguration ceremony, this past January 2nd. The following is a direct quotation from that letter:

"...As President, I will try to ensure that the federal government does its part to help Puerto Ricans with the issues that they face...The Administration will consider the circumstances and needs of Puerto Rico as it develops and implements policies that would substantially affect the island..."

To date, I am sorry to report, the recommendations of the Executive Branch -- with respect to Section 936 -- have contradicted that promise. They also contradict the intended purpose of President Clinton's policy of providing opportunity for all Americans.

We in Puerto Rico support the President's objectives, and are fully prepared to assume our proportionate share of the burden. Indeed, we strongly endorse many of the Administration's specific proposals...among them, the rebuilding of our nation's infrastructure, and reform of the health-care system.

In one key area, however, Executive Branch policy-planners seem to have lost sight of President Clinton's bottom line: that, of course, is *jobs*...jobs for American citizens.

Nowhere is the need for jobs greater than in Puerto Rico, where unemployment exceeds 18 percent -- two-and-one-half times the national level...where per-capita income is less than 30 percent of the national average...and where the proportion of families subsisting on poverty-level incomes approaches 60 percent -- while the mainland figure stands at about ten percent.

Despite these data, the Administration is advocating Section 936 amendments that would actually *cripple* our island's capacity to attract -- and even to retain -- job-creating private-sector investment.

Currently, more than 105,000 Puerto Rico residents are employed

directly by firms operating under Section 936. These companies also create a significant number of indirect additional jobs, elsewhere in our economy.

Section 936 employees account for almost 70 percent of the manufacturing jobs in Puerto Rico...and approximately 11 percent of the island's total employment. Accordingly, whenever the Federal government contemplates changing Section 936, it is of vital importance to Puerto Rico's government that such changes imperil neither the island's current employment, nor its future economic development. What is in essence a marginal decision for the Federal government is a vital and central issue of economic survival to Puerto Rico.

However, peril is pervasive in the Administration's latest Section 936 modification plan.

We estimate that these proposals:

- Would reduce the annual tax-benefits of Section 936 companies by more than 60 percent;
- Would increase the effective tax rates of such enterprises to a level that, when Puerto Rico tax levies are factored in, would leave the island non-competitive;
- Would drain the pool of Section 936 funds by 75 percent;
- And would slash, by amounts ranging from 25 percent up to 75 percent, the tax benefits pertaining to companies that employ over 66-thousand persons...or just about two-thirds of all the men and women now working at Section 936 enterprises.

That is what I mean by pervasive peril.

None of this is intended to imply that the status quo is ideal. Section 936 *can* be rendered more effective. I am not here to insist that this incentive program be treated as a sacred cow. As I have already said, Puerto Rico is fully prepared to accept its proportionate share of sacrifice, in the national interest.

Nevertheless, using whatever parameters you may choose, the sacrifice being proposed by the Executive Branch is *dis*proportionate...and is crippling to our objective of building a competitive economy.

The inequity, to which I refer, can easily and dramatically be quantified. The Administration's national economic blueprint envisions sacrifice, in the form of tax increases, that total about twelve-hundred dollars-per-person in the average state. Puerto Rico, by contrast, would be expected -- solely through changes in Section 936 -- to generate new federal

revenue at a level equivalent to two-thousand dollars-per-person.

In the context of relative income differentials, this is *six times more* than the contribution per capita being sought from mainland citizens.

By any yardstick, that is unfair.

Moreover, we must also keep in mind the extraordinary economic challenges that Puerto Rico confronts:

- Although the island's population density is 15 times the national average, Puerto Rico's current territorial political status has left our people without full access to many basic services -- just last week, the Census Bureau revealed that Puerto Rico trailed all 50 states in Fiscal 1992 Federal spending per person, receiving barely *half* the amount spent in an average state...obviously, that helps explain why our economy is less robust;
- The provisions of the North American Free Trade Agreement would reduce our ability to compete with foreign countries, for several types of labor-intensive enterprise;
- And I respectfully submit that, in any of your states, 18 percent unemployment would constitute a dangerously explosive situation.

Yet it is against this backdrop, on the premise that it can yield $7.3-billion in revenue over the next five years, that the Executive Branch of the Federal Government today advocates the virtual destruction of Puerto Rico's principal economic development tool.

This cannot be decided merely as a numbers game. The President has asked us to "put people first." That is precisely our plea to the Senate, the House of Representatives, and the White House.

President Clinton has stated that he wants to create more jobs, better jobs, and higher-paying jobs for the American people. Where Puerto Rico is concerned, the Administration's current proposal would do just the opposite.

All rational analysis shows that the Administration's current proposal will result in a weakened, more-dependent economy...a significant loss of American jobs...greatly diminished local tax revenues...and higher capital costs.

The price tag on that projected $7.3-billion in new revenue is simply too high. It sadly reminds me of the Vietnam war story, about the village that supposedly had to be "destroyed in order to save it": the Federal Government cannot foster renewed economic growth by *taking jobs away* from

a community of 3.6-million American citizens that needs *new* jobs perhaps more than any other!

As an alternative to the Administration's plan, we propose the enactment of an incentive comprised of two options...

Under the first option, a 936 firm would receive a tax credit, equal to the sum of:

- The total compensation it pays to its employees;
- All of the corporation's Puerto Rico income and tollgate taxes;
- Federal income taxes attributable to the company's qualified possessions source investment income; and
- Ten percent of its new capital investment in plant, machinery and equipment.

OR, under the second option, the 936 corporation would receive an income-based credit that would be phased down to 90 percent of the existing Section 936 credit in 1994, and to 80 percent in subsequent years. This plan would provide new Federal revenues of 2.8-billion dollars.

Today we bring before you this proposal, which will allow Puerto Rico to participate in the sacrifices being asked of all Americans, but which will also permit us to build a more productive, more competitive, and less dependent economy. We seek not handouts, but instruments for productive development.

Our proposal -- which I am submitting to you in more detail as an addendum, and which I urge you to accept -- offers a realistic approach to revenue-enhancement...and thus to proportionate shared sacrifice by Puerto Ricans. *Un*like the Administration's proposal, this plan has broad-based backing from labor, business, financial, and professional organizations on the island, as well as Latino and Hispanic leadership groups on the mainland.

But most of all, my proposal provides a foundation upon which Puerto Rico can continue to construct a more self-sufficient economy...one that will propel us closer to equality...equality of rights, equality of opportunity, equality of responsibility...the equality with which you and your constituents are blessed.

We ask for this as fellow American citizens.

Thank you very much.

COMPARISON OF THE EXECUTIVE BRANCH AND GOVERNOR PEDRO ROSSELLO PROPOSALS FOR SECTION 936

1. INTRODUCTION

The Executive Branch has submitted a plan to cap the benefits available to participating firms operating under Section 936. This proposal allows companies operating in Puerto Rico to exempt an amount of profit, not to exceed 60% of the FUTA wages paid by the firm, from federal taxation. On the surface this may seem like an innocuous change to the Section 936 provision. However, this is not the case. In the succeeding sections of this memorandum we will explain why this proposal will cause severe economic problems in Puerto Rico. As a matter of urgent necessity the Governor of Puerto Rico has had to develop an alternative to the Executive Branch's proposal that would be fair to the 3.6 million U. S. citizens residing in Puerto Rico and that would also address the objectives of the U. S. Treasury.

2. THE EXECUTIVE BRANCH PROPOSAL II

The Executive Branch has made two proposals concerning changes with Section 936. The more recent version of their proposal specifies that:

(a) the operating earnings elegible for the 936 credit cannot exceed 60% of the FUTA wages paid by the firm; and,

(b) the qualified possession source investment income ("QPSII") will be limited such that the amount of assets that can be invested to earn QPSII cannot exceed 80% of the firms' adjusted tangible assets in Puerto Rico.

3. SHORTCOMINGS OF THE EXECUTIVE BRANCH PROPOSAL II

The Executive Branch proposal imposes severe economic consequences upon Puerto Rico's economy. More specifically, we identify the following specific consequences resulting from their proposal:

(a) The Executive Branch proposal is designed not to make any type of firm better off, but to make the majority of the firms worse off. Specifically, the way the incentive is structured, it makes the most labor intensive firms no worse off than they are under the current system, but it makes the more capital intensive high tech firms worse off than they currently are by the imposition of new federal taxation.

The Executive Branch proposal has an adverse impact (i.e.

results in a new federal tax liability) upon almost 60% of the firms operating under Section 936. These firms which are adversely affected, presently employ 63% of all Section 936 employees and account for almost forty percent of the entire manufacturing employment in Puerto Rico.

Puerto Rico has been losing labor intensive jobs to third world countries for the last twenty years. There has been a 32% loss in labor intensive jobs since 1973! Our recent employment growth in the high tech sectors has offset losses in the labor intensive sectors and enabled the island to maintain the same level of manufacturing employment for the last twenty years.

By making the high tech sectors worse off than they are under the current system the Administration proposal will reduce future employment growth in these high tech sectors. As a result of this fact, combined with the normal loss of labor intensive jobs to low-wage countries, we will begin to evidence real job losses in the manufacturing sector.

The NAFTA agreement will accelerate the loss of labor intensive and moderate capital intensive jobs to Mexico. This will futher intensify the adverse force of the Treasury proposal on Puerto Rico's economy.

(b) The Executive Branch proposal includes a cap based solely upon the actual wage paid. In our opinion the employee's full compensation should be incorporated into the cap amount. Fringe benefits and payroll taxes are an integral component of the labor cost that a firm bears for hiring a worker. In order for Puerto Rico to maintain our competitive position for labor intensive jobs relative to locations such as Mexico and the Dominican Republic we must include the total compensation under the cap. Our fringe benefits alone in Puerto Rico, for labor intensive jobs, are higher than the entire compensation paid to workers in these third world countries.

(c) The Executive Branch proposal is one dimensional in that it attempts to provide an incentive to the labor intensive sectors for employing workers. It does not provide any incentive for the employment of capital in plant, equipment and machinery.

(d) The Executive Branch proposal does not consider the Puerto Rican tax base and will result in the substantial loss of tax revenues to the Government of Puerto Rico. The Administration proposal could result in the loss of some 15% to 18% of the general revenue funds (all personal and corporate income taxes, all inheritance and gift taxes, all license fees, and all excise taxes collected on local consumption) of the government. This sizeable loss in the Government's tax base is a devastating problem.

(e) The Executive Branch proposal is basically unfair and

inequitable to the people of Puerto Rico. On average the revenue raising aspects of the President's package raise $1,200 per person for the nation as a whole. However, for Puerto Rico the Treasury proposal for Section 936 alone raises $2,000 per person. This represents a significant difference, almost 75% more, in the per capita revenues to be raised in Puerto Rico from the Executive Branch's program.

When the relative income of Puerto Rico versus that for the whole nation is factored into the analysis, the relative burden on Puerto Rico is six times more than that for the nation as a whole.

3. <u>THE ROSSELLO PROPOSAL</u>

The Governor of Puerto Rico, Dr. Pedro Rossello, has developed a proposal that deals in a fair and responsible, manner with possible revisions to Section 936. This proposal consists of two options that a participating firm may choose. One option includes a total compensation based cap upon the Section 936 credit and the second option is an income based incentive. Each of these will be briefly detailed below (the full proposal is attached as an appendix to this memorandum):

(a) <u>Compensation Based Option</u> A Section 936 firm electing this option may not take a Section 936 credit that is greater than the sum of: (1) 100% of the FUTA wages, fringe benefits and payroll taxes attributables to its workers in Puerto Rico; plus (2) an investment tax credit of 10% of the new investment in plant, machinery and equipment; plus (3) taxes paid to the Government of Puerto Rico (up to a maximum of 9%) on the earnings of the business enjoying the benefit of Section 936.

In addition, a firm's qualified possession source investment income ("QPSII") earnings retain their current exclusion from federal taxation.

Those firms, which have excess credits when the total credits exceed the tax liability from the Section 936 firms' operations, may utilize these excess credits against their combined taxable income attributable to products manufactured in Puerto Rico.

To insure that firms hire employees to engage in productive work and not simply to maximize their total compensation credit we have incorporated strict limitations within Governor Rossello's proposal for Section 936.

(b) <u>INCOME BASED OPTION.</u> A firm may select an income based incentive which provides: (1) 90% of the Section 936 credit during 1994; and (2) 80% of the Section 936 based credit in 1995 and for all succeeding years.

This option also continues the full exemption for the

qualified possession source investment income.

This alternative reduces by 20% the tax benefits of those more profitable companies which would not elect the total compensation based option. This 20% reduction is greater than the amount proposed last year by the Chairman of The House Committee On Ways And Means.

4. UNDERLYING RATIONALE FOR GOVERNOR ROSSELLO'S PROPOSAL

The overiding consideration for the Rossello proposal is to insure that Section 936 generates a sufficient number of new job opportunities for the 3.6 million U. S. citizens residing in Puerto Rico, and to do so in a cost effective manner. The Rossello proposal accomplishes this goal. The specific elements by which this is accomplished are:

(a) The Rossello proposal includes two options. One option will be attractive for the high tech capital intensive firms and one option will be more attractive to the more labor intensive firms. The Executive Branch proposal was one dimensional and did not have an attraction for the high tech capital intensive types of firms. By having two specific options, one that appeals to each type of firm, the Rossello proposal addresses this issue. We will provide an array of incentives to attract the full spectrum of firms.

(b) The Rossello proposal results in a fair increase in the federal tax burden upon the most profitable firms operating under this provision. By doing so there will be a significant amount of revenue raised for the U. S. Government to reduce its deficit. However, these changes will not impair the incentive program for the future development of Puerto Rico.

(c) The Rossello proposal permits our workers to obtain high-skilled, high-wage jobs in an expanding high-tech manufacturing sector along with, and not exclussively as in the Executive Branch proposal, labor intensive jobs that can be promoted with our inclusion of the combined taxable income concept into the revised incentive program.

(d) The maintenance of the concept of qualified possession source investment income in the incentive program will retain the advantage of lower cost investment funds for Puerto Rico's economic development funding requirements.

(e) The allowance for the full credit of taxes paid to the Puerto Rican government will avert a major budget problem for our government. Under the Executive Branch program the Puerto Rico Government could lose up to 15% to 18% of its total tax revenues. This is not a problem under the Rossello alternative.

APPENDIX A: SECTION 936 PROPOSAL

OF GOVERNOR PEDRO J. ROSSELLO

I. A Section 936 Corporation will be entitled to compute the Section 936 tax credit, at their option, under either of the following formulas:

A. A Section 936 credit equal to the sum of the following, against the Combined Taxable Income for products manufactured in Puerto Rico by the electing corporation, as defined in IRC Section 936(h) (5) (C) (ii) (II):

(i) 100% of total compensation, including all fringe benefits and payroll taxes;

(ii) All Puerto Rico income taxes and withholding taxes on dividends, paid by the 936 corporation, up to a 9% effective tax rate;

(iii) All U. S. income taxes on the qualified possession source investment income ("QPSII"); and,

(iiii) An amount equal to 10% of investments in plant, machinery and equipment placed in service by the 936 company after December 31, 1993. This would be available for use in the year when the investment is placed in service, or during any of the following two taxable years, at the option of the taxpayer.

The maximum amount of compensation to be taken into account for each employee will be limited to the amount subject to federal social security withholding (currently $57,600), and the 936 corporation will be entitled to a full deduction for compensation paid.

The credit for investments would grant incentives for future investments in plant, machinery and equipment in Puerto Rico, and should provide full depreciation for investments in plant, machinery and equipment.

Special rules and limitations would be established to avoid the possibility of increases in compensation and tax credits without a corresponding increase in business operations in Puerto Rico, solely for the purpose of benefiting from the total compensation credit against combined taxable income. These limitations would only allow credits for future compensation increases to the extent they fall within a 1990 to 1992 average benchmark ratio of total compensation to net sales. Exemptions from the benchmark ratio would be available if the 936 corporation

is able to justify, subject to Treasury's audit, that the ratio should be raised: (i) due to expansion of operations and added production in Puerto Rico which is more labor intensive; (ii) hiring during 1994 of a number of workers which is equal to its 1991-1992 average of temporary workers or; (iii) hiring of workers which previous to 1993 had worked directly as contractors, or employees of contractors for the 936 corporation. Furthermore, consistent with the significant business presence rules of IRC Section 936(h)(5)(B)(iii)(II) and IRC Regulations Section 1.936.5(c) Question and Answer Number 4 for contract manufacturers, compensation paid by a 936 corporation would include the labor costs of contract employment agencies; if these can be established, otherwise 50% of the amounts paid to contract manufacturers, independent contractors or temporary employment agencies, provided the contract manufacturer, independent contractor or temporary employment agency is not a Section 936 corporation and all their services are rendered within Puerto Rico.

B. The current Section 936 credit is reduced to the following percentages:

1994	90%
1995 and in succeeding years	80%

In addition, the Section 936 corporation will be entitled to a full Section 936 credit for "QPSII" subject to the current "QPSII" limitations.

SUMMARY OF GOVERNOR ROSSELLO'S PROPOSAL

							OPTION A USABLE CREDITS'					OPTION A & B	
YEAR	GROWTH	ACTIVE INCOME	INCOME RETAINED	NET INCOME	EFFECTIVE TAX RATE	U.S. TAX LIABILITY	100 % C/C	10 % CAP INVEST.	P.R. TAX PAID	C.T.I. CREDIT	TOTAL	U.S. REVENUES OPTION A	COMBINED U.S. REVENUES
1989		7,123.4 *											
1990	1.10	7,835.7											
1991	1.10	8,619.3											
1992	1.10	9,481.2											
1993	1.09	10,334.6											
1994	1.08	11,162.3	80 %	8,929.8	30 %	2,679.0	1,640.6	41.0	276.4	108.0	2,066.0	613.0	267.0
1995	1.07	11,943.7	80 %	9,554.9	30 %	2,866.5	1,728.5	25.2	292.9	104.2	2,150.8	715.7	572.0
1996	1.07	12,779.7	80 %	10,223.8	30 %	3,067.1	1,815.2	22.8	310.7	100.5	2,249.2	817.9	613.0
1997	1.07	13,674.3	80 %	10,939.4	30 %	3,281.8	1,902.2	20.6	336.3	97.1	2,356.2	925.6	655.0
1998	1.07	14,631.5	80 %	11,705.2	30 %	3,511.6	1,993.6	21.2	363.6	93.7	2,472.1	1,039.5	701.0
				51,353.2		15,406.0	9,080.1	130.8	1,579.9	503.5	11,294.3	4,111.7	2,808.0

Disbursed Projects
Endorsed Projects by the Office of the Commissioner of Financial Institutions
As of May 4, 1993

Projects		Jobs P.R.	Jobs Caribe	Financial Institution	936 Loan	Industry
BARBADOS						
Barbados Bottling Co. LTD		n/a	n/a	Partners	950,000	Maquinaria Industrial
Barbados Telephone Co.		n/a	n/a	Scotiabank	13,000,000	Infraestructura
Barbados Telephone Co.		n/a	132	Bankers Trust	22,000,000	Infraestructura
Bondhus		n/a	27	Partners	150,000	Productos Fabricados de Metal
Financiamiento 936	4	n/a	159		36,100,000	
Total para Barbados	**4 proy.**	**n/a**	**159**		**36,100,000**	
COSTA RICA						
Catanzaro		n/a	30	Partners	650,000	Turismo
Chiquita Brands		n/a	7,200	Bankers Trust	38,000,000	Agroindustria
Coopesa		n/a	120	Partners	500,000	Metal y Productos de Metal
Escosa		n/a	165	Citibank	2,500,000	Productos de Concreto
INCESA		n/a	92	Partners	999,000	Manufactura de Lozas
Inv Cen-Am		n/a	140	Partners	300,000	Agroindustria
Inversiones Zeta		n/a	220	Citibank	5,000,000	Infraestructura
Lovable Brassiere Co.		n/a	400	Partners	600,000	Textil
Paraiso Verde		n/a	100	Partners	900,000	Agroindustria
Searle Pharmaceutical Prod. **		n/a	33	Citibank	1,628,000	Quimicos y Productos Relacionados
Texaco Costa Rica		n/a	240	Citibank	4,049,000	Comercio al Detal
Tico Verde		n/a	100	Partners	900,000	Agricultura
Financiamiento 936	11	n/a	8,777		53,748,000	
Pl. Gemela con Fondos 936	1	n/a	33		1,628,000	
Total para Costa Rica	**12 proy.**	**n/a**	**8,810**		**55,376,000**	
DOMINICA						
ABC Container **		15	50	Citibank	2,100,000	Papel y Productos Relacionados
Pl Gemela con Fondos 936	1	15	50		2,100,000	
Total para Dominica	**1 proy.**	**15**	**57**		**2,100,000**	
GRENADA						
Grenada Telephone Co.		n/a	40	Bankers Trust	8,000,000	Telecomunicaciones
Financiamiento 936	1	n/a	40		8,000,000	
Total para Grenada	**1 proy.**	**n/a**	**40**		**8,000,000**	
HONDURAS						
Adhotel		n/a	50	Partners	980,000	Turismo
CAHSA		n/a	150	Partners	999,000	Agroindustria
Hondutel I		n/a	300	Chase	76,000,000	Telecomunicaciones
INDEMA		n/a	475	Partners	550,000	Madera y Productos de Madera
INDEMA II		n/a	255	Partners	200,000	Madera y Productos de Madera
Rio Nance		n/a	14	Partners	250,000	Agroindustria
Financiamiento 936	6	n/a	1,244		78,979,000	
Total para Honduras	**6 proy.**	**n/a**	**1,244**		**78,979,000**	

Projects		Jobs P.R.	Jobs Caribe	Financial Institution	936 Loan	Industry
ISLAS VIRGENES EE. UU.						
Sapphire Beach Resort		n/a	200	Citibank	9,135,000	Turismo
Financiamiento 936	1	n/a	200		9,135,000	
Total para I.V.E.U.	**1 proy.**	**n/a**	**200**		**9,135,000**	
JAMAICA						
Air Jamaica		n/a	30	Drexel	51,000,000	Servicios
Alcan		n/a	n/a	Citibank	60,000,000	Metal y Productos Relacionados
Alpart		n/a	75	Paine Webber	60,000,000	Metal y Productos Relacionados
Jamaica Broilers		n/a	83	Citibank	3,000,000	Alimentos
Jamaica Grande, Ltd.		n/a	100	Chase	27,000,000	Turismo
Jamaica Inter Telecom		n/a	594	Scotiabank	6,000,000	Telecomunicaciones
Jamaica Tel. Co. LTD I		n/a	125	Scotiabank	22,000,000	Telecomunicaciones
Jamaica Tel. Co. LTD II		n/a	n/a	Scotiabank	6,086,000	Telecomunicaciones
Jamaica Tel. Co LTD III		n/a	n/a	Scotiabank	5,400,000	Telecomunicaciones
Rosehall		n/a	n/a	Chase	10,000,000	Turismo
Transcaribbean Cable		n/a	n/a	Chase	17,000,000	Servicios
U D C / Transhore		n/a	n/a	GUB	8,700,000	Servicios
Financiamiento 936	12	n/a	1,007		276,186,000	
Total para Jamaica	**12 proy.**	**n/a**	**1,007**		**276,186,000**	
REPUBLICA DOMINICANA						
Bratex		n/a	400	Partners	520,000	Ropa y Textiles
Caribbulk		n/a	6	Partners	999,900	Agroindustria
Caribex		n/a	100	Citibank	1,620,000	Procesamiento de Alimentos
Caribex II		n/a	n/a	Citibank	810,000	Procesamiento de Alimentos
Fiesta Bavaro Hotel		n/a	305	Central Corp./Bilbao	22,000,000	Turismo
Hotel Embajador		n/a	17	Com.Mguez/Bilbao	2,500,000	Turismo
Metaldom		n/a	240	Scotiabank	27,500,000	Metales y Productos Relacionados
Metaldom II		n/a	n/a	Scotiabank	2,500,000	Metales y Productos Relacionados
NSS Caribe		n/a	200	Citibank	4,500,000	Enseres Eléctricos y Electrónica
Seaboard		n/a	24	Chase	18,000,000	Infraestructura
Financiamiento 936	10	n/a	1,292		80,949,900	
Total para R. D.	**10 proy.**		**1,292**		**80,949,900**	
TRINIDAD & TOBAGO						
Amoco Oil		n/a	113	1st Boston/Chase	75,000,000	Producción de gas natural
Mobil Oil		n/a	n/a	Scotiabank	35,000,000	Exploración de Petróleo
Phoenix Park		n/a	50	Citibank	80,000,000	Refinería de Petróleo
Texaco Trinidad		n/a	n/a	Scotiabank	20,000,000	Exploración de Petróleo
Financiamiento 936	4	n/a	163		210,000,000	
Total para T & T	**4 proy.**	**n/a**	**163**		**210,000,000**	
TOTAL PARA FINAN. 936	49	n/a	12,882		753,097,900	
TOTAL PARA PL. GEMELAS/ Financiadas con fondos 936	2	15	83		3,728,000	
TOTALES	51	15	12,965		756,825,900	

Mr. ROMERO-BARCELÓ. Thank you, Mr. Chairman and members of the committee.

Chairman ROSTENKOWSKI. Mr. O'Neill, Mr. Podolin, Mr. Gordon, Mr. Murphy, gentlemen, I think several of you know the routine here. You are allocated 5 minutes. If you have a longer statement than that, we would appreciate it if you summarize. I want you to understand, however, that the warning light only comes on 4 minutes into your testimony, which then signals the red light which gives you the 5 minutes that you have been allocated. We would like for you to stay within that framework. If however you are closing down on a statement, we understand that.

So having said that, when I recognize you, would you please identify for the record your title so that the court reporter can record it.

Mr. O'Neill, if you are ready, the committee is ready to take your testimony.

STATEMENT OF ALBERT C. O'NEILL, JR., CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. O'NEILL. Thank you, Mr. Chairman. My name is Albert O'Neill. I am chair of the Section of Taxation of the American Bar Association, and I am appearing today here on behalf of the association.

I would like to discuss some of the proposals before you solely from the standpoint of certain tax policy and tax administration positions. My testimony will not support or oppose any particular proposal. Even though I may express some concerns, we recognize that the broader policy considerations you must take into account as you deliberate may well dictate a different result than would be reached if you simply used the tax policy principles that we will be discussing.

Our basic position is to urge the committee to proceed with great caution before adopting changes that run counter to the overall purposes and achievements of the Tax Reform Act of 1986. The American Bar Association has strongly supported the fundamental objectives of the 1986 act, and we continue to believe in the benefits to our tax system that flow from the simplicity, efficiency, and fairness created by a broad base with lower rates. Because of these views, we do have some serious tax policy concerns about the proposed new tax incentives.

In your deliberations, we urge you to remember well the reasons for tax reform. In effect, we ask that you give strong consideration to the impact of each new proposal on the perceived and actual fairness of the system, on the neutrality of the system, and on the simplicity of the system. Consideration also needs to be given to the cumulative effect of the changes. What may not be that great of a deviation from the tax policy principles we advocate when considered in isolation may well be very damaging when combined with other changes.

I would like to take a look now at some of the specific proposals before you in light of tax policy principles. For example, take the investment tax credit provisions. We believe they raise numerous fairness concerns, particularly when viewed by service and other noncapital intensive industries; and for those businesses that are

able to use the ITC, is it fair to distinguish between them on the basis of size?

In our written comments we have also raised other fairness concerns about the ITC proposals. These proposals also present neutrality concerns, as do the enterprise zone proposals. We must make sure that enterprise zones do not become the tax shelters of the 1990s.

The proposed increase in ordinary income rates will create over a 12 percent disparity in rates between capital gains and ordinary income at the top end. We believe that this spread will be sufficient to cause high income taxpayers to spend considerable time once again planning their transactions so as to convert ordinary income into capital gains. The targeted capital gains proposals will obviously exacerbate the situation.

Then there are the so-called negative preferences—for example, the denial of deductions for certain compensation in excess of a million dollars and the denial of deductions for lobbying expenses. We believe that these provisions are just as contrary to the principles of tax reform as are the positive incentives. Our tax system is one that seeks in general to tax net income, not gross income, and when one starts to deny deductions for legitimate business expenditures, on what basis does one draw a rational and consistent line?

All of these proposals will also add to complexity, both in the planning aspects and in the administration of the system.

Having pointed out what we perceive to be some tax policy and tax administration concerns with many of the President's key economic proposals, let me reiterate what I said at the beginning. We are not suggesting that these proposals be rejected. In a particular case economic and social policy concerns may well outweigh the tax policy concerns. What we do urge is that the tax policy objectives that we have advanced not be regarded lightly.

Before closing, I would also like to make two brief comments about the process. First, we are greatly concerned about the impact that complexity has on compliance. If a targeted proposal is to be enacted, we would urge that the rules governing the incentive be kept just as simple as possible, even at the risk of having some unintended benefits made available to taxpayers.

Second, we understand the time pressures that you face, but we urge the committee and the administration to release legislative language for review by groups such as ours just as soon as possible, and in any event before decisions are made. The Section of Taxation is more than willing and welcomes the opportunity to work with the staff in analyzing and ironing out technical issues raised by the legislative proposals. As in the past, we gladly volunteer our services in this regard. Thank you.

[The prepared statement follows:]

TESTIMONY OF ALBERT C. O'NEILL, JR.
ON BEHALF OF THE AMERICAN BAR ASSOCIATION

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

March 17, 1993

Mr. Chairman and Members of the Committee:

My name is Albert C. O'Neill, Jr. I am the Chair of the American Bar Association's Section of Taxation. I am testifying today on behalf of the American Bar Association at the request of J. Michael McWilliams, President of the Association.

The Association recognizes the need for the Congress to deal positively with the President's proposals to reduce the deficit and address other national issues. There seems to be widespread agreement that deficit reduction is one of our most important national priorities. Other critical national policies to be considered include social policies, such as how progressive the federal tax system should be; economic policies, such as the need for public and private investment; and policies that relate to using the income tax as a vehicle for raising needed revenues in a fair and efficient manner.

The ABA Tax Section does not claim expertise in matters of social or economic policy, nor have we been elected to make ultimate decisions that balance competing economic policy, social policy and tax policy concerns. Our primary expertise lies in an understanding of tax policy issues, tax system design issues inherent in policy choices, the application of the Internal Revenue Code to individuals and business entities, and tax administration from both the taxpayer's and the government's perspectives. Through our 25,000 members, we have broad experience with the extent to which taxpayers respond to opportunities to reduce taxes by arranging their activities to make use of tax incentives or preferences. We also have first-hand experience with the extent to which complexity and uncertainty in the tax law can have unintended effects on business and investment activity.

My testimony today will not support or oppose any particular proposal. The policy considerations that must be taken into account by this Committee may well justify a different conclusion in a given instance than would be reached based on the tax policy and tax administration considerations that I will address.

Our general position is that the Committee should proceed with great caution in adopting changes that run counter to the overall purposes and achievements of the Tax Reform Act of 1986. As you may recall the ABA strongly supported the fundamental objectives of the 1986 Act -- broadening of the tax base and reduction in tax rates -- in 1985 and 1986. We also testified before this Committee in February 1990 and February 1992, expressing our continued strong support for these principles. As tax practitioners, we continue to believe in the benefits to the tax system that flow from the simplicity, efficiency and fairness created by a broad base with lower rates.

As a result, we have serious tax policy and tax administration concerns about the combination of increased rates and new tax incentives in the Administration's tax proposals. Admittedly, deficit concerns may influence the deliberations on higher rates, and social and economic policy considerations may influence the deliberations on tax incentives for particular investments. However, we would urge the Committee to remember well the reasons for tax reform as it considers the degree to which it should increase rates and provide new preferences:

1. Fairness.

The preferences that had accumulated in the tax code before 1986 caused taxpayers with similar incomes to pay widely varying amounts of income tax. Individuals and corporations with substantial economic incomes were able to pay little or no tax by using these preferences. These factors created a perception that the tax system was unfair, which undermined the general public's respect for the tax laws.

Tax reform's elimination of preferences and tax shelters has had a significant impact on the effective progressivity of the tax system. The broadening of the tax base has meant that many people with significant income pay a higher effective tax rate on their income than they did before tax reform, even though nominal rates were lowered.

2. Efficiency or Neutrality.

Preferences distorted economic decisions, channelling funds into investments based on their tax results rather than their economic return. Tax shelters clogged the tax administrative process as well as the courts and threatened the continued health of our income tax system.

3. Simplicity or Administrability.

The existence of preferences and special rules forced taxpayers to determine whether they fit within the favored group or not, and the IRS had to make similar determinations as part of the audit process. Taxpayers understandably sought to fit their transactions within one of the favored categories, thus giving rise to transactional complexities and the artificial structuring of transactions and investments.

Many tax proposals designed to address economic ills are problematic when examined from the perspective of the generally agreed goals of tax reform. Even though a proposal may seem to be harmless (or nearly so) in isolation, the accumulation of such "innocent" provisions over time produces a tax code that the public regards as so unfair that compliance suffers. We are concerned that the reintroduction of preferences -- in the name of economic incentives -- will return us to the very problems that tax reform was intended to solve.

The types of problems that concern us can be illustrated by several of the proposals that have been put forward. Without suggesting that any particular proposal raises more concern than others, let me give some examples of how we view several proposals against the backdrop of the goals of tax reform:

1. Fairness.

Fairness concerns are raised by proposals such as the investment tax credit, which will result in taxpayers with similar incomes paying different amounts of tax. Taxpayers in service businesses and other industries with little tangible capital will question the fairness of a provision that subsidizes certain types of tangible capital. In addition, the incremental nature of the credit for large businesses raises serious fairness issues for those who have spent their

available capital on substantial recent investments or who have otherwise recently completed their anticipated expansions for the immediate future. The temporary nature of the large business credit raises fairness issues for investments committed before the beginning date but occurring during the credit period, as well as those committed before the end of the credit period but made later. Why should a business that has committed to the investment before the credit period begins get the credit, and one that commits to the investment during the credit period not get it? That is the proposal as we understand it. Finally, the differentiation between small and large businesses creates its own set of fairness issues. Why are small businesses more worthy of tax relief than larger ones? And what divides large and small businesses?

2. <u>Efficiency or Neutrality</u>.

While an ITC could also be used as an example of a proposal that is contrary to the principle of tax neutrality, the enterprise zone proposals serve equally well. The proposals are specifically designed to induce certain types of investments, as opposed to tax reform's goal of letting market forces direct investments. Serious attention must be given to preventing enterprise zones from becoming the tax shelters of the 1990's.

Some of the Administration's proposals would introduce "negative preferences" by denying deductions for certain business expenses that should be deductible in a system that seeks to tax net income rather than gross income. The denial of deductions for compensation exceeding $1 million and the denial of deductions for lobbying expenses are examples.

From a tax policy perspective, if compensation is paid or accrued and is not a disguised dividend, it should be deductible. If the payment of such compensation is not deemed to be acceptable, limitations could be imposed outside the Internal Revenue Code.

Negative preferences are just as contrary to the principles of tax reform as positive preferences, such as the ITC and enterprise zones. We are concerned that once Congress starts down this road, consistent tax policy is abandoned and there are no principled bases for decision-making. Any expense that is vaguely associated in the public mind with some undesirable activity or event may be fair game. Deductions could be denied for oil spill clean-up expenses or environmental clean-up expenses generally, or for expenses of advertising "junk food," etc. By what standards should proposals such as these be judged once we get away from the idea of taxing net income?

3. <u>Simplicity or Administrability</u>.

One example of a proposal that raises complexity concerns is the proposal to recreate a sizeable capital gains preference through significant increases in the top individual rate on ordinary income and targeted capital gains relief. Significant capital gains differentials are bound to reintroduce the transactional complexity that was eliminated by the 1986 Act. As intended by the preference, taxpayers will

seek to structure their activities, transactions, and investments so as to receive favorable capital gains treatment. Attempting to convert ordinary income into capital gain will once again become a central feature of tax planning. The concept of limiting the special exclusion to "qualified small business stock" introduces a dimension of complexity not present in prior law and will undoubtedly lead to efforts to convert nonqualifying gains into qualifying gains through various techniques.

The limitations on the deductibility of executive compensation will require difficult and complex rules and decision-making as a result of the proposal to exempt compensation based on "productivity."

The incremental investment tax credit also raises complexity and administrability concerns. Complex rules will be needed to deal with leasing transactions, investments through partnerships, and recapture of the credit as a result of dispositions or reduced levels of investment in the future. In many circumstances, tax lawyers may be unable to advise businesses as to whether an investment will qualify for the credit because information necessary to compute the "base" may be in the hands of third parties (such as lessors) and because subsequent events that cannot be predicted may affect a business's ability to receive the full benefit of the credit.

Having pointed out what we perceive to be tax policy and tax administration problems with many of the President's key economic proposals, let me hasten to reiterate that we do not suggest that, all things considered, any specific proposal must necessarily be rejected. In a particular case, economic and social policy considerations may well outweigh tax policy and tax administration concerns. It is the unenviable task of this Committee to weigh all of these considerations in reaching its decision. At the same time, we hope that this Committee will not regard lightly the adverse impact of the proposals from a tax policy and tax administration perspective.

Before closing, I would like to comment on two additional points. The first relates to the complexity of our tax law. We believe that complexity has reached the point that substantial numbers of taxpayers are unable or unwilling to spend the money necessary to comply fully with the tax law. Major contributors to the current level of complexity are the frequency of legislative change and, in a number of instances, a striving for conceptual purity that resists practical compromise with the real-world concern of administrability. Highly targeted proposals, the scope of which may be constrained by revenue considerations, inevitably raise substantial complexity concerns. We hope that in drafting targeted provisions, the Committee will be mindful of the complexity being engendered, particularly where the provision will affect large numbers of individuals. In this regard, we urge the Committee to measure the number of affected individuals not simply by counting those whose returns ultimately reflect application of the provision but by also counting those who must analyze the provision as it applies to their fact situation in order to determine whether they fall within the affected group or not.

Second, although we understand the desire to move quickly on a tax bill, we urge the Committee and the Administration, to the extent possible, to release legislative language for study by groups such as ours before the legislation is agreed

to. Chairman Rostenkowski is to be commended for following this procedure with respect to recent legislative proposals (such as simplification and technical corrections). Affording affected taxpayers and professional groups the opportunity to review legislative language in advance improves the quality of the legislation and goes a long way toward fostering faith in the fairness of the legislative process. The ABA Tax Section would welcome the opportunity to work with the staff in ironing out technical issues raised by legislative proposals. We volunteer our services and believe that as experienced practitioners and advisers we can be helpful to the process.

* * *

In sum, the ABA urges the Committee to be mindful of the achievement of tax reform and to question carefully the wisdom of provisions that run counter to that achievement. Although we recognize that many factors outside our area of expertise should properly be considered by the Committee in deciding whether a particular type of tax legislation is advisable, we urge the Committee to proceed cautiously. It will be difficult indeed to regain ground once lost.

I would be happy to respond to any of your questions.

Chairman ROSTENKOWSKI. Thank you.
Mr. Podolin.

STATEMENT OF LEONARD PODOLIN, IMMEDIATE PAST CHAIRMAN, TAX EXECUTIVE COMMITTEE, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PODOLIN. Good morning, Mr. Chairman, I am Leonard Podolin, the immediate past chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants. Unfortunately, our executive committee chairman, Harvey Coustan, is unable to be with us today, but I am privileged to replace him in representing our 310,000 members.

The AICPA has for some years now been urging simplification of our tax system. Year after year, statistics indicate that about half of the individual taxpayers feel it necessary to hire a professional preparer to comply with their tax return obligations. Many of our members are beneficiaries of this fact. Nonetheless, we advocate simplicity as an important tenet of a tax system that aims for voluntary compliance.

We acknowledge that we live in a time of highly complex financial transactions and that considerations of economics and equity can't be ignored. We understand that there will necessarily be some complex tax provisions. However, Congress needs to consider carefully whether we are approaching a point of diminishing returns—no pun intended—concerning the respect for the tax system and for voluntary compliance.

Congress is obviously not unaware of this problem. We appreciate the past and present efforts of this committee's chairman to include a simplification title in a tax bill, including the introduction of H.R. 13 earlier this year. Over the past several years, we have been pleased with the approach to "rough justice" generally espoused in the Treasury Department and the Internal Revenue Service, and we hope that will continue.

Still, Congress must not lose sight of the need to relentlessly pursue simpler laws. The government's interest, as well as those of taxpayers are served by less complexity. Document matching alone can't replace the lack of IRS audit resources in a tax world as complex as ours. In short, complexity carries a real cost to the tax system through lower levels of compliance by taxpayers, whether inadvertent or intentional, combined with the inadequate resources of the IRS to provide adequate monitoring. Complexity and lowered respect for the system also come from what we call back-door approaches to tax policy.

We believe our Government can and should be more open with the American people. For example, rather than imposing a 10 percent surtax on individual taxable incomes that exceed $250,000, why not just create a 40 percent or 39.6 percent bracket in the Internal Revenue Code? Instead of making permanent the personal exemption phase out and the 3 percent limitation on itemized deductions, why not recognize that this is a back-door marginal tax rate increase on individuals at particular levels of income and translate that into a direct tax rate increase which would affect that approximate group of individuals.

We believe a simpler tax system is one that first defines the tax base more directly and then raises revenues through adjustment of the rates, something that political and other considerations seem not to have allowed in the past several years. We believe that should change. Speaking of the need to simplify, consider the investment tax credit, both the permanent and the incremental proposals. The complexities inherent in the administration's proposal, especially the incremental credit, are such that a disproportionate amount of taxpayer and IRS resources will be required to ascertain that compliance levels are correct. All for what, to a specific taxpayer, may well be a relatively modest benefit. Thus we suggest that a direct rather than an incremental credit should be employed if possible.

Perhaps more importantly the proposal seems to promise much more than it is likely to deliver to most taxpayers. Our written comments on page 3 give an example of what we believe will be a fairly typical situation where the presumed 7 percent credit really amounts to approximately 2 percent.

We are also concerned with two proposals that raise the standard for the accuracy-related and preparer penalties and that modify the tax shelter rules for purposes of the substantial understatement penalty. This area of the law was amended after a well-thought-out collegial review of penalties by the Congress, Treasury, the IRS, and professional organizations that took almost three years and concluded only as recently as 1989. It is entirely reasonable for taxpayers to have the right to take a position on a tax return without risk of penalty provided that the position is not clearly wrong and the position is disclosed.

If the law were black and white without the uncertainties and gray areas that presently exist, our view on this might be different. However, given the fact that the law is subject to much interpretation, taxpayers should not be precluded from taking positions they believe have merit.

The stated reason for the change in the Treasury release is that "taxpayers and preparers should try to comply with the tax laws in a reasonable manner." Given the nature and the state of the tax law today, that is an alarmingly simplistic statement. Is it unreasonable for a taxpayer to take a position where the law is unclear if the position is fully disclosed? Shouldn't the taxpayer have a right to a day in court without actually paying the tax and suing for a refund? Courts do decide cases in favor of taxpayers, who should not have to face a choice of giving in to an IRS interpretation or going to court to avoid a penalty.

Ironically taxpayers would no longer have an incentive to disclose their positions where they take a position where the law is unclear.

Let me conclude with some concerns we have about effective dates. A number of the proposals have retroactive effective dates that we fear will create an unnecessary administrative and compliance burden for the IRS, for taxpayers, and for tax professionals. As just one example, the extension of the research and experimental credit and a number of the other expired provisions applies to expenditures paid or incurred after June 30, 1992. Implementing this provision retroactively would require many businesses that

have paid or incurred such expenses after that date to file amended income tax returns and would require the IRS to process numerous refund claims.

We believe the costs of compliance with a retroactive date are not an appropriate tradeoff for the benefits sought, and we believe there is a more reasonable alternative, such as requiring the taxpayer to claim the credit on a 1993 return rather than having to amend a 1992 return. We also foresee a problem with implementing rate changes on January 1, 1993, the problem resulting because of the failure to revise the withholding tables. A year from now some taxpayers will find that they are receiving a smaller refund than anticipated or have a balance due when they expected a refund or owe a lot more money than they thought they were going to owe. This situation will create a negative impression of the tax system for these taxpayers and it will no doubt exacerbate the IRS' already severe collection problems.

Even though the issue affects only upper income taxpayers, it will become more serious the farther into the year that this legislative process proceeds. At some point prospective application of rate increases must be given serious consideration because bunching up of the increase will be untenable.

Finally, let me mention that our written comments include thoughts on a number of proposals that are not contained in the administration's tax plan but that we hope will be given serious consideration. We will submit more comprehensive comments by the April 6 deadline for inclusion in the printed record and once again we very much appreciate the opportunity to present our views today, and we stand ready to assist this committee in any way we can.

[The prepared statement and a supplemental statement follow:]

STATEMENT OF LEONARD PODOLIN
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction

Good morning. I am Leonard Podolin, Immediate Past Chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants. Unfortunately, our Executive Committee Chairman, Harvey Coustan, is unable to be with you today, but I am privileged to replace him in representing our 310,000 members. The AICPA is the national, professional organization of CPAs of whom many (if not most) advise clients on tax matters and who prepare returns for millions of taxpayers.

We are not economists or politicians; our interests are sound tax policy and administration. Nonetheless, our members have a substantial interest in, and strongly support, President Clinton's stated goals of fostering public investment and achieving deficit reduction. We also urge, however, that tax policy objectives be accomplished, where possible, through simpler, more direct law changes. We thank the committee for the opportunity to offer our suggestions. Please note that our comments this morning are based on the Treasury Department February 25, 1993, release summarizing the Administration's revenue proposals. Because of the time constraints imposed by the scheduling of this hearing, we will submit more comprehensive comments by the April 6 deadline for inclusion in the printed hearing record.

Simplification

The AICPA has, for some years now, been urging the need for simplification in our tax system. Year after year, statistics indicate that approximately one-half of individual taxpayers feel it necessary to hire a professional preparer to comply with their tax return obligations. Many of our members are beneficiaries of this fact; nonetheless, we are strong believers in the need for constant attention to simplicity as an important tenet of a tax system that aims for voluntary compliance.

We recognize that we live in a time of highly complex financial transactions, and that considerations of economics and equity are also critical. Thus, we understand that there will continue to be a need for complex tax provisions. However, Congress needs to consider carefully whether we are approaching a point of diminishing returns (no pun intended) concerning respect for the tax system and for voluntary compliance.

Congress is not unaware of the problem. We appreciate the past and present efforts of this committee's chairman to include a simplification title in a tax bill (see our testimony below with respect to H.R. 13). Over the past several years, we have been pleased with the approach to "rough justice" generally espoused in the Treasury Department and the Internal Revenue Service. We hope that will continue.

Still, it is critical that Congress not lose sight of the need for continuous efforts toward a simpler law. Given the limited resources of the Internal Revenue Service to audit returns, the government's interests, as well as those of taxpayers, are served by less complexity. Document matching alone cannot replace this lack of other audit resources in a tax world as complex as ours. In short, complexity carries a real cost to the tax system through lower levels of compliance by taxpayers (inadvertent and illegal) combined with the inability of the government (through lack of resources) to provide adequate monitoring.

Complexity, and lowered respect for the system, also come from "back door" approaches to tax policy. We believe our government can, and should, be more open with the American people. For example, rather than imposing a 10 percent surtax on individual taxable incomes greater than $250,000, why not put a 40 percent (or 39.6 percent) bracket in section 1 of the Code? Instead of making permanent the personal exemption phaseout and the 3 percent limitation on itemized deductions, why not recognize that this is a back door marginal tax increase on individuals at particular levels of income, and translate that into a direct rate increase which would affect that approximate group?

We believe a simpler tax system is one that first defines the tax base more directly, and then raises revenue through adjustments of the rates - something political and other

considerations seem not to have allowed in the past number of years. We believe that should change.

Investment Tax Credit. In this regard, with respect to the Administration's proposals, you need to consider the investment tax credit, both permanent and incremental. The complexities inherent in the proposal, especially the incremental credit, are such that a disproportionate amount of IRS resources will be required to ascertain that compliance levels are correct - and for what, to a specific taxpayer, may well be a relatively modest benefit. Thus, our suggestion is that a direct, rather than an incremental credit, should be employed if possible.

Further, in addition to the major definitional and computational complexities, the proposal seems to promise more than it is likely to deliver - to most taxpayers. First, while the nominal rate is 7 percent, the only taxpayers who will receive that rate on qualified investment are "small" businesses investing in 10-year property (barges, tugs, fruit trees, limited other items). As a practical matter, the great bulk of purchased assets will fall in the 5-year or 7-year categories, which produce a lower ITC.

For the incremental credit, there is a further limitation, to 50 percent of qualified investment. Thus, the incremental ITC for larger businesses can never exceed 3.5 percent of qualified investment. The incremental credit is then scaled down to reflect whether property is less-than-10-year property. Finally, the amount of the credit is taken back into income (at taxpayer's highest bracket) ratably in 1995-7.

Consider the acquisition of a $10,000 asset with a 7-year life:

Nominal credit @ 7%		$700
Limitation: 3.5% of investment ($10,000 x 50% x 7%)		$350
Less 20% for 7-year property		(70)
Maximum credit		$280
Additional tax payable in 1995-7 ($280 x 34%)	$95	
Discounted for later payment		(85)
Value of ITC		$195

Thus, a presumed 7 percent credit has worked its way down to an approximate 2 percent credit - and at a cost of tremendous complexity.

(We do recognize that the credit can be up to 7 percent of incremental investment - but that only occurs where the result would be smaller than a 3.5 percent credit on qualified investment. Thus, we believe the above example is appropriate.)

We have several other comments on the ITC:

- We are pleased that there is at least a partial offset against the alternative minimum tax for the investment tax credit, since to deny that would merely be to take back with one hand what Congress has given with the other. We have not had the time to conclude, through research, that a reduction of tentative minimum tax by 25 percent (as proposed by the Administration) will give substantial alleviation from the AMT for investment in qualified property, but if subsequent investigation indicates significant problems in this area, we will supplement these comments.

- The credit is permitted on the amount of qualifying investment in excess of a determined "fixed base" for either 1989-91 or 1987-91. However, used property purchases in the base years would increase the amount of fixed base investment, while used property purchases in 1993 or 1994 would not qualify for the credit, which seems inconsistent. Using the same type of property to build the base but not be counted for current year acquisitions, simply reduces or eliminates a taxpayer's credit in two ways. We fail to understand why there is no parallelism in the treatment of used property.

- We would hope that committee reports mandate flexibility in the drafting of regulations applying to the determination of base period acquisitions. While depreciation records should provide the bulk of the information needed, such items as qualified progress expenditures will be most difficult to reconstruct going back to 1987 or 1989. Further, since there has been no investment tax credit (except for carryovers) since 1986, requiring reclassification of acquired property from 1987 on into ITC categories (3 years, 5 years, etc.) will likewise cause some substantial complexity, including multiple calculations for many taxpayers who will find - after having gone through it all - that they either are not entitled to the credit or that it will be nominal in size for them. Your committee's report could save many taxpayers untold hours if it directed that regulations should seek to avoid multiple sets of calculations, and that good faith efforts at record reconstruction should be respected.

- In our general ITC comments, above, we noted the scaleback of the credit due to its inclusion in income over the recapture period, for larger taxpayers. However, even for small businesses (perhaps, especially for small businesses), the complexity of basis adjustments to offset part of the ITC's cost to the government is unwarranted and should, if revenue considerations dictate, be replaced with a lower credit rate in the first place. One wonders why it is necessary to reinstate the rules requiring that the amount of the credit reduce depreciation basis for acquired assets, in the case of the small business credit. The result is the credit given in year one is taken back (in part) over later years, thus both reducing its effective benefit and adding further complexity to our tax laws. If a 7 percent credit is too expensive, why not make it a 6 percent credit but allow it to be reflected only once on the tax return.

Modified Substantial Understatement Penalty

We are concerned with the two proposals which raise the standard for accuracy-related and preparer penalties, and modify the tax shelter rules for purposes of the substantial understatement penalty. This area of the law was amended a few years ago after a well thought out, collegial review of penalties by the Congress, Treasury, IRS, and professional organizations that took almost three years and concluded only in 1989.

Taxpayers should have the right to take a position on a tax return without risk of penalty provided that the position is not clearly wrong and the position is disclosed. If the law were black and white, without the uncertainties and gray areas that presently exist, our view on this might be different. However, given the fact that the law is subject to much interpretation, taxpayers should not be precluded from taking positions that they believe have merit. A stated reason for the change, in the Treasury release, is that "Taxpayers and preparers should try to comply with the tax laws in a reasonable manner." Given the nature and state of tax law today, that is an alarmingly simplistic statement. Query -- is it unreasonable for a taxpayer to take a position where the law is unclear if the position is fully disclosed; i.e., shouldn't the taxpayer have the right to "a day in court" without actually paying the tax and suing for a refund? Courts actually do decide cases in favor of taxpayers, and taxpayers should not have to face a choice of giving in to an IRS interpretation or going to court to avoid paying a penalty.

The proposal with respect to the tax shelter rules is to require a taxpayer to demonstrate that the reasonably anticipated tax benefits from the shelter do not significantly exceed the reasonably anticipated pre-tax economic profit in the shelter. This requirement would be in addition to the requirement that the tax shelter item has "substantial authority" and that the taxpayer believed that the claimed treatment was "more likely than not" the proper treatment. We are also opposed to this provision. From an economic perspective, an investor should consider the tax benefits in determining whether or not an investment makes economic sense and whether the investor will obtain an adequate return on the investment. However, the fact that the Internal Revenue Code contains certain tax incentives (provided by Congress) should not result in a penalty against a taxpayer who utilizes those incentives where he believes that a position with respect to the shelter is more likely than not the proper position.

Targeted Small Business Capital Gains Proposal

As with the investment credit, the targeted nature of the capital gains incentive seems likely to add new layers of substantial complexity to the law. We have reservations about the definitional language in the Treasury summary, and may articulate them as details become available.

One point we would bring to your attention now is that this proposal applies only to C corporations. However, currently 40 percent of all filing corporations are S corporations, and S corporations clearly tend to be smaller businesses. We suggest the Administration's interest in helping small business is not aided by excluding the 40 percent of the corporations most likely to be small in the first place.

Earned Income Tax Credit

The Administration initiative in the February 25 Treasury Department release is entitled: "Expansion and Simplification of Earned Income Tax Credit." The proposal (to be detailed in the Administration's Budget) is to "expand" the credit.

We trust a substantial effort will be made, in this proposal, to simplify the credit as well. The credit is most important to low-income taxpayers, and it is one item many of them ignore or miscalculate because of its difficulty to understand and apply.

We would be pleased to assist any efforts to give this very difficult area a badly needed overhaul.

Effective Dates

A number of proposals have retroactive effective dates that we fear will create an unnecessary administrative and compliance burden for the IRS, taxpayers and tax professionals. For example, the extension of the research and experimentation credit (and a number of the other so-called expired provisions) applies to expenditures paid or incurred after June 30, 1992. Implementing this provision retroactively will require many businesses that have paid or incurred such expenses after that date to file amended income tax returns, and the IRS to process numerous refund claims. This situation should cause you to ask yourselves whether the costs of compliance with a retroactive date are an appropriate trade-off for the benefits sought; and whether there is not a more reasonable alternative, such as requiring the taxpayer to claim the credit on a 1993 return rather than having to amend 1992.

Another problem we foresee with implementing rate changes on January 1, 1993 involves failure to revise the withholding tables. A year from now, some taxpayers will find that they 1) are receiving a smaller refund than anticipated: 2) have a balance due when they expected a refund; or 3) owe a lot more money than they thought. Not only will this situation create a negative impression of the tax system for these taxpayers but it will exacerbate IRS' already severe collection problems. Even though the issue affects only

upper-income taxpayers, it will become more serious the farther into the year the legislative process goes. At some point, prospective application of rate increases must be given serious consideration.

Provisions Not Yet Included in the Clinton Tax Proposals

Tax Simplification

Mr. Chairman, we commend you on your continued efforts on behalf of tax simplification by the introduction of H.R. 13 earlier this year. We hope that package of general simplification measures, as well as the important intangible improvements, will be included in this year's major tax legislation.

Individual Estimated Taxes

We believed the changes to individual estimated tax rules enacted in November 1991 were overly complex and burdensome and experience has proven that taxpayers cannot comply with them. These rules have got to be fixed but we do not endorse the revenue raising approach adopted in H.R. 11 last year that affected all taxpayers; rather, the correction should be targeted only to upper income individuals in a manner that allows compliance with certainty.

50 Percent Excise Tax on Pension Plan Reversions

IRC section 4980 imposes a 50 percent excise tax on reversions upon termination of defined benefit pension plans. If a replacement plan is established using 25 percent of the reversion or if benefits to employees are increased, the excise tax is 20 percent instead of 50 percent.

This 50 percent excise tax produces a harsh, unintended result in the case of a small business owner who terminates a defined benefit plan at the same time the business is terminated, for example, when the business owner retires, dies or becomes disabled. When the 50 percent excise tax is added to the regular federal and state income tax, the total tax associated with the reversion can exceed 90 percent.

This problem for small business owners could be solved by amending section 4980 to state that the 20 percent, rather than the 50 percent, excise tax will apply where the plan termination takes place as a result of (or within 60 days prior to) the cessation of the employer's business. This exception could be limited to employers with less than a specified number of employees or some other definition of small business.

Estimated Tax Rules for Corporations Which are Not Large Corporations

Under present law, corporations that have any prior year tax liability, regardless of the amount, either regular or alternative minimum, may utilize this liability as a "safe harbor" for current year estimated tax payments. However, a corporation with a net operating loss must base its estimated tax payments on its current year taxable income. This requirement can create an unnecessary burden for many small businesses.

The AICPA endorses a change in the rules to allow a corporation that is not a "large corporation" to use the prior year safe harbor when the previous year's tax returns showed a zero tax liability and that taxable year was a taxable year of 12 months.

* * * * *

Once again, we appreciate the opportunity to present our views here today and we stand ready to assist you in any way.

ADDITIONAL COMMENTS OF THE TAX DIVISION
American Institute of Certified Public Accountants

Investment Tax Credit

In the AICPA's March 17 testimony, we used the proposed incremental investment tax credit as an illustration of complexity added to the Code for what will turn out to be a relatively nominal benefit for many taxpayers. One of the points we made was that, as a practical matter, the nominal 7 percent credit could never exceed 3.5 percent of qualified investment, even though it could be as high as 7 percent on incremental investment. However, we think it worth noting for this Committee that, even on an incremental basis (and before any scaleback of the credit based upon cost recovery life), the higher the level of investment, the lower will be the effective rate of the ITC. In fact, once incremental investment reaches one-half of qualified investment, the effective rate of the credit begins to decrease from 7 percent trending toward 3.5 percent. Note the following examples, all of which assume a "best case" scenario in which property has a 10-year life -- most property has a 5 or 7-year life which will make the tax results even less beneficial. (See discussion in our March 17, 1993 statement.)

	A.	B.	C.	D.
1. Qualified investment	12,000	20,000	50,000	100,000
2. Fixed base (assumed)	10,000	10,000	10,000	10,000
3. Incremental investment	2,000	10,000	40,000	90,000
4. 50% limit on qualified investment	6,000	10,000	25,000	50,000
5. Credit (7% x lesser of lines 3 or 4)	140	700	1,750	3,500
Credit as percent of qualified investment	1.2	3.5	3.5	3.5
Credit as percent of incremental investment	7.0	7.0	4.4	3.9

Our March 17 statement pointed out that the ITC proposal seems to promise more than it is likely to deliver, for many taxpayers. The above examples strengthen that concern.

Increase In Estate and Trust Tax Rates

While we have deliberately stayed away from the debate as to the "right" top rates for individuals and corporations, the AICPA believes the Administration's proposed higher tax rates on estates and trusts are unfair. The proposals sharply reduce the current 15 percent tax bracket from taxable income of $3,750 to $1,500 and the top of the 28 percent tax bracket from $11,250 currently to $3,500. The next $2,000 of taxable income would be subject to the 31 percent tax rate and everything above that would be taxed at the new 36 percent rate. And, incomprehensibly, the new 39.6 percent surtax on "high income" taxpayers would apply to estates and trusts having taxable income in excess of only $7,500. Individual taxpayers will be subject to this new surtax generally only when their taxable income exceeds $250,000.

The high tax rates proposed for estates and trusts would generally force executors and trustees to distribute income to the beneficiaries, something that may not be desirable or even permitted under state estate administration law or allowed under the provisions of the trust instrument.

There will be only slight (if any) additional revenue from this proposal, as executors and trustees will generally decide to pay out the income to beneficiaries who will likely be taxed at lower rates (certainly with respect to the surtax). In fact, it is conceivable, even probable, that these proposed rates would actually decrease revenue since most individual beneficiaries would not be subject to the 36 percent tax bracket until their taxable income exceeds, for example, $115,000 (single) and $140,000 (joint return). And, as already noted, most individuals would not be subject to the 10 percent surtax until their taxable income exceeds $250,000.

The tax law should not set traps for the unwary so that an inexperienced executor or trustee erroneously retains income, with a heavy tax exacted. Existing trusts that require retention of income in certain circumstances, such as until a child reaches a certain age, should not be penalized by a change in the law that cannot be avoided. In cases where an executor or trustee has discretion to distribute income and believes that the estate or trust objectives would be better served by retaining income, the fiduciary should not have to decide between compromising on these objectives or paying higher taxes. It is wrong for our tax laws to impose taxes at a penalizing level where an executor or trustee is charged with a fiduciary responsibility and may well be sued for an income-retaining decision that costs substantially more tax or for an income-distributing decision that may not be consistent with the spirit of the will or trust instrument.

There is nothing sinister or subversive about estates and trusts. An estate is created when an individual dies. The executor merely steps into the shoes of the decedent and collects income and pays expenses until disposition of the assets and liabilities of the estate. Generally, decedents do not plan the times of their deaths, and an executor wants to wind up an estate as soon as possible but may not be able to do so for various reasons. There is no reason for a discriminatory tax in this situation.

Trusts are set up for a variety of purposes, many of which are socially desirable, such as care of surviving spouses, minors, orphans, incompetents, the elderly, and the handicapped. Again, Congress and the Administration should consider the many worthwhile purposes served by trusts and reconsider levying a harsh income tax against them.

We urge you to adjust the proposed rates downward to the same level as the individual income tax rates, or at least to the current differential between the rates for individuals and those for estates and trusts. The current rates already weigh heavily in favor of distribution of income, and discourage accumulation sufficiently to force the executor or trustee to carefully consider their fiduciary responsibilities in relation to the additional taxes. For example, the highest individual rates are those applicable to married persons filing separate income tax returns; trusts and estates were taxed at these rates prior to the 1986 Tax Reform Act.

Deny Deduction for Executive Pay Over One Million Dollars

The Administration proposes to deny a deduction for "executive" compensation exceeding $1 million a year, except where compensation payments are linked to "productivity." We do not support this proposal for the following reasons.

Tax policy calls for taxpayers to be taxed on their net income as opposed to gross income. On this basis, corporations are allowed to deduct their ordinary and necessary business expenses. To establish an arbitrary limitation on such deductions is contrary to this policy. Further, the suggested approach strikes us as a first step down a slippery slope in an area that should be driven by the marketplace rather than the government. If today's perception of "fairness" says that a million dollars is an appropriate cap for deductibility, does tomorrow's review of the fairness issue (combined with revenue needs) suggest reducing that cap to say, $700,000? (This is not solely a theoretical question - see our comments below on the proposal to increase the non-deductible portion of meals and entertainment from 20 percent to 50 percent.)

Under section 162(a)(1) and the associated regulations, deductions are allowed for reasonable salaries and other compensation paid for personal services actually rendered. The present proposal is inconsistent with the ability of corporations and executives to negotiate an arm's-length reasonable compensation package to be deducted under existing laws because compensation in excess of one million dollars will be, by statute, nondeductible.

The example contained in Reg. § 1.162-7(b)(1) indicates there is consideration given to the relationship of the parties when the reasonable compensation test is applied. Generally this relationship is important when there is a closely-held corporation, where there is no independent evaluation to determine the reasonableness of the compensation paid to majority shareholders or officers of the corporation. The opportunity to pay "unreasonable" compensation to executives of publicly-held corporations is limited by the review of shareholders and outside boards of directors. The compensation paid to an executive is more appropriately a corporate governance issue to be addressed by shareholders and boards of directors.

One further policy consideration needs to be addressed. If this proposal becomes law, who will really pay for the change? In very few instances will it be the executive. "Sign-up" bonuses and the amount of compensation required to attract the level of qualified managers needed to deal with decision-making in a highly complex and competitive multi-national world will, absolutely, be dictated by market forces and not the tax law. Consequently, and most properly in our view, there will continue to be compensation packages negotiated which exceed $1 million a year, and where whatever productivity standards are legislated (see our comments below on this subject) will not be met. In those situations, the additional tax burden on the corporation will be reflected in lower earnings available to the shareholders, a lower valuation of net corporate assets, or higher prices to customers.

The concepts of "productivity" and "business performance" would require carefully crafted definitions. A few of the possible issues to be considered under the definition are hours worked, number of people supervised, gross income of the entity, net income of the entity, current revenues and expenses as opposed to those amounts accrued prior to the individual becoming the executive, the number of divisions reporting to the individual, the geographic area reporting to the executive, stock price, earnings per share of the company, return on equity, historical financial performance of the corporation, and the impact of corporate acquisitions or divestitures on the profits of the entire organization. Also, all of these concepts should probably be evaluated against the performance of other corporations in the industry. The potential complexity required to provide clear guidance to taxpayers and the IRS will, we expect, rival that of the transfer pricing regulations.

In addition to the above, a company's Board of Directors may set productivity goals for, say, a CEO that do not emphasize the same criteria as the proposed legislation (or implementing regulations). It is questionable, at least, as to the propriety of substituting Congressional judgement for that of a Board having fiduciary responsibility to determine when appropriate productivity and performance has been achieved.

The issue of stock options can be particularly troubling. An option held over a five-year period can be "cashed in" in year six, with over $1 million of income reported. That income may represent, however, a five-year, steady rise in stock price, largely caused by the executives' efforts and shared in by all stockholders through increases in the value of their holdings. It would be perverse to have the efforts of a group of employees enhance shareholder value by billions of dollars but for their compensation to be limited to $1 million each vis-a-vis tax deductibility. This issue needs to be addressed in defining productivity or performance standards.

Finally, administrability of this provision is likely to prove difficult, given the inevitable subjectivity of many of the standards we discuss above. We suggest the likelihood exists of continuous difficult negotiations with examining IRS agents, increased litigation, and a generally disproportionate expenditure of taxpayer and government resources for the very small class of taxpayers affected, and for the well-under-$1 billion of revenues projected to be raised by the provision over the 5-year budget window.

Reduce Deductible Portion of Business Meals and Entertainment to 50 Percent

Disallow Deduction for Club Dues

Businesses do not run on a 9 to 5 schedule. While eating is a necessity, and while business entertaining certainly contains an element of personal consumption (not always pleasure - how many business people would rather be spending an evening at home with the family rather than participating in a required function?) the arbitrary decision that 50 percent is the "correct" amount to attribute to business, rather than the 80 percent decided upon by Congress just seven years ago; or that no part of club dues arises from anything but pleasure, makes one wonder how these particular standards for ordinary and necessary business expenses are being developed. We just don't agree with the stated reasons for implementing these changes.

Actually, Congress has already considered the personal element of meals, entertainment, and club dues, and has put in stiff limitations on their deductibility. Section 274 requires a direct relationship to a taxpayer's business for these types of expenses to be deductible, and then only if certain hurdles are overcome with respect to percentage of business use, documentation, etc. If the message is that section 274 is too difficult to administer and an arbitrary disallowance rate (50 percent or 100 percent) is easier, we would then ask whether such an approach is "fair" (a number of the present proposals, including these, are presented in the name of fairness). Are these proposals even an approximation of "rough justice", a legislative concept we generally support? We doubt it. While we have no statistics, we believe that for every individual enjoying an expense account lunch which otherwise meets the standards of section 274, there is at least one other individual participating in a meeting with others in the office, eating a dry sandwich and drinking a soda, while lunch hour is ignored in favor of continuing to work.

We also question the seemingly broad application of the club dues provision. The deductibility rules under section 274 already require a more than 50 percent business purpose use test. Should a club meet that criteria, only that portion of the dues that is "directly related to the active conduct of such trade or business" is deductible. Since the parameters of appropriate business use have been established, the Administration's proposal should not be so overly broad as to deny legitimate business deductions. A luncheon club, for example, is likely to be used for bona fide business purposes over 90 percent of the time; yet dues would be 100 percent disallowed under the proposal.

Disallow Moving Deductions for Meals and Real Estate Expenses

We do not support a change to the moving expense rules with respect to meals. The deduction for moving expenses was introduced into the law in 1964 (PL 88-272). At that time, the definition of moving expense included meals while traveling from the former residence to the new residence. Over the past 28 years, several changes to section 217 have been enacted, including an expansion of the deduction to include house hunting trips and temporary quarters. From its enactment and through changes to the law, Congress has consistently recognized that travel from the old to the new home, house hunting trips, and temporary lodging all require extraordinary costs to the taxpayer in the form of lodging, meals, and transportation. The administration states that "moving does not generally increase the cost of meals because the taxpayer would have eaten meals at either location." We believe that is an oversimplification: there is no comparing the cost of meals while traveling to the cost of eating at home. Congress has correctly realized, when enacting and expanding the moving expense deduction, that meals are an integral part, as well as an incremental part, of traveling expense and moving.

Increase Recovery Period for Depreciation of Nonresidential Real Property

The provision would extend the recovery period for nonresidential real property to thirty-six years because, according to the Treasury Department summary of the Administration's revenue proposals, current depreciation allowances "exceed the actual decline" in property value. We do not agree that this is an appropriate standard to be applied. Since adoption of the Accelerated Cost Recovery System (ACRS) in 1981, and continuing through today with the modified ACRS system, there has been relatively little attempt to equate tax depreciation lives with anything but an approximation of economic life, or with actual decline in value of the asset. It is unclear to us why it becomes necessary to start moving back toward an "actual decline in value" concept, and for one class of assets only.

If, however, Congress believes it important to lengthen the life of business realty, we believe you should consider the following. As the building life for tax depreciation approaches its economic life, tenants paying for leasehold improvements become more disadvantaged. If the cost recovery period for business real estate is extended to 36 years, we believe Congress should legislate a separate, shorter, depreciation class for tenant-provided leasehold improvements and for other known shorter-life assets, which presently are included in depreciation of the overall building.

Allocate R&E Expense to Place of Performance and Treat Royalties as Passive Income for Purposes of Foreign Tax Credit Limitation

The first part of the proposal would allocate R&E expense to the place of performance of the associated R& E for foreign tax credit limitation purposes. Thus, domestic research expense need not be allocated against foreign source income. This provision makes sense in that it is logical and easier to administer. We generally support its adoption.

The second aspect of the proposal would treat all foreign source royalty income as income in the separate foreign tax credit limitation category for passive income, whether or not royalties are derived in the active conduct of a trade or business, and whether or not they are received from a related party. No transition rules have been announced.

The provision treating royalty income as passive will increase the tax burden borne by U.S. companies and make them less competitive abroad because most foreign competitors are in countries with an exemption system or a less complicated foreign tax credit system. This provision would discourage U.S. companies from exploiting the benefit of licensing technology where it is not commercially feasible to export goods.

We do not agree with the passive treatment of foreign royalties. We believe such treatment discourages the transfer of technology abroad. It discriminates against those who receive royalty income from abroad rather than sales income, and will make many U.S. companies less competitive abroad because of the inability to fully utilize foreign tax credits on all foreign income.

Require Current Taxation of Certain Earnings of Controlled Foreign Corporations

The proposal would require U.S. shareholders owning 10 percent of certain CFCs to include in income currently their pro rata share of a specified portion of the CFC's current and accumulated earnings. The proposal would apply to a CFC (including a CFC that is a PFIC) holding passive assets representing 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includable earnings") would be the lesser of (a) total current and accumulated earnings and profits, or (b) the amount by which the value of the CFC's passive assets exceeds 25 percent of the value of its total assets. Includable earnings would be adjusted to account for amounts previously taxed. For this purpose, passive assets would be defined as under the PFIC rules (including the definition of passive income thereunder.) This would be in addition to any passive income generated by the passive asset which would be taxed currently under subpart F, or other anti-deferral regimes.

Example: If a CFC had $100 value of assets, $30 of which was passive, its income inclusion as a result of the proposal -- when fully implemented -- would be $5 (assuming that at least $5 of current and accumulated earnings and profits were available), since $30 is $5 more than (25% x $100).

Multinationals from all countries seek to do business where labor and transportation costs are lowest. By increasing the tax cost of doing business abroad, this provision makes U.S. multinationals less competitive with respect to foreign counterparts. Moreover, the provision discourages passive investment of funds while business searches for the best use of those funds. The provision therefore may result in hasty investments which will harm U.S. multinational competitiveness. This proposal is another "chip" at the deferral regime. As the deferral benefit gets smaller and smaller, U.S. competitiveness from operating abroad is reduced.

Enhance Earnings Stripping and Other Anti-Avoidance Rules

The proposal would treat any loan from an unrelated lender that is guaranteed by a related party as related party debt for purposes of the earnings stripping rules. Except as provided in regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures (on an unconditional or contingent basis) the payment of another's obligation. For purposes of determining whether the interest paid on the guaranteed debt is exempt from U.S. tax, the fact that the lender is subject to net basis U.S. taxation (as opposed to U.S. withholding tax) on its interest income would not be taken into account. This proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993.

Guarantees by a parent corporation of its subsidiaries' debts are commonly required by lenders and often have no connection with eroding the U.S. tax base. By presuming guarantees are abusive, the provision will discourage foreign investment in the U.S. and could result in a loss of U.S. jobs. Also, by considering all guarantees abusive, the proposal does not distinguish between the acceptable commercial uses of guarantees and abusive situations. This provision may result in retaliation against U.S. companies operating abroad through foreign subsidiaries.

In addition, we are concerned with the summary of the proposal which states, ". . . the fact that the unrelated lender is subject to net basis United States taxation on its interest income would not be taken into account." This statement is so overly broad as to encompass domestic lenders (with no foreign activity) subject only to U.S. taxation.

Subchapter S Improvement - (Not Presently in Administration's Proposal)

Subchapter S is available only for certain corporations that can meet sharply defined requirements such as a maximum number of shareholders, a single class of stock, and certain types of shareholders. These strictures make Subchapter S more complicated to use, foreclose certain types of financing vehicles, necessitate unnecessarily complex corporate structures to manage liability concerns, and create a number of "traps" into which business owners can unwittingly fall with serious results. These problems reduce the utility of Subchapter S for small businesses.

The AICPA, together with the American Bar Association and the U.S. Chamber of Commerce, has developed a proposal consisting of 26 separate changes to Subchapter S. The proposals are designed to:

- Make small businesses in the form of S corporations more attractive investment vehicles for venture capitalists.
- Enable owners of S corporations to more easily plan for the succession of their businesses to younger generations of employees.
- Permit S corporations to separately incorporate different portions of their businesses to control liability exposure.

- Simplify Subchapter S to remove traps that cause small business owners to shy away from using the S corporation business form or cause unnecessary tax planning to avoid jeopardizing the S election.
- Place S corporations on a par with other forms of doing business and S corporate owners on a par with small business owners using other business forms.

We look forward to working with the committee on this proposal in detail and to work toward its enactment.

Chairman ROSTENKOWSKI. Thank you, Mr. Podolin.
Mr. Gordon.

STATEMENT OF ARTHUR I. GORDON, PRESIDENT-ELECT, NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. GORDON. Good morning, my name is Arthur Gordon. I am president-elect for the 33,000-member New York State Society of CPA's. With me is Janice Johnson, the society's director of tax policy.

Thank you, Mr. Chairman, for having us appear before you today. Based on our profession's deep involvement in the financial affairs of millions of individual and business taxpayers we possess a unique microeconomic perspective that few others have. This enables CPA's, perhaps more than any other group, to understand how taxpayers will react to the impact of specific tax proposals.

With our limited time here today we cannot comment on all the provisions. However, we believe that they should all 'be made as simple as possible within the framework of achieving the objectives of economic stimulus and tax equity.

We are especially concerned that the benefit of certain provisions intended to stimulate investment and economic growth, such as the investment tax credit with built-in sunset provisions, will be outweighed by the cost and inconvenience of administrative complexity.

Now, in particular the investment tax credit. We believe the investment tax credit should be made available to all businesses, not just manufacturing and technology. It is unclear to us from the provisions we have read so far that this would be the case. Furthermore, in order for businesses to plan their projects, they must have a permanent ITC for both large and small businesses. We feel this is very desirable.

Finally, enacting an incremental credit, we believe, puts at a disadvantage companies that had the foresight to invest during the recession and, in fact, punishes them for being an advocate in the economy. In terms of the passive loss provisions, the society supports those provisions, especially the ones applied to active real estate professionals which exempts them from the passive loss rules. We think this is long overdue.

In terms of exempting charitable gifts of appreciated property from the AMT, we are in support of this provision, too. We particularly are concerned that post 1992 this will apply both to securities and to real estate. We believe that for purposes of simplicity and fairness this should be the case.

Self-employed health insurance deductions. We agree with Congressmen Grandy and Brewster and Senator Dorgan that the health insurance deduction for the self-employed should provide parity with corporate businesses and should be made permanent. Such legislation would benefit farmers, entrepreneurs, and, yes, accountants and attorneys.

On the individual income tax rates, we generally support the need for increased individual income tax rates to help reduce the deficit. As CPAs, we do not contend that a particular rate is right or wrong. However, we do favor open and honest rate adjustments to raise or lower revenue rather than hidden floors, ceilings, per-

centage disallowances and other mechanisms designed to hide the actual result of tax increases. Accordingly, we favor a fifth rate rather than a maximum rate plus a stated surcharge.

It is important to point out that many of the historic pre-1988 credits and deductions have been deleted from the Code, so in fact although rates now, even as proposed, look lower than rates in the past, they will, in fact, be a higher effective rate than in the past. These increases affect various geographical locations differently.

Clearly a married couple filing a joint return at the proposed 36 percent threshold of $140,000 has a very different standard of living in New York and Washington than in Syracuse. We believe that this should not be—we believe that this should be considered in any rate increases.

Disallowance of various ordinary and necessary business expenses. The proposal calls for limitation and disallowance of a number of ordinary and necessary business expenses which currently meet the test of the Internal Revenue Code. As a matter of economic and tax policy we do not believe that businesses should be hindered by the tax laws in the global economy from making spending decisions. In terms of the proposal for lobbying expenses, we believe that this will hurt many small businesses. The complexities clearly outweigh the advantages, and we believe a de minimis clause should be enacted in such a law if it was enacted.

In terms of the compliance initiatives, we agree with the AICPA that this was hammered out in the past and we believe that any change now would be counterproductive.

In terms of the capital gain modifications, we are in favor of these. However, we feel that the complexity will not allow investors as an incentive to invest in the growing businesses they are meant to support. We therefore believe that whatever incentives are given should keep simplicity in mind. Thank you again, Mr. Chairman, for allowing us to testify.

Chairman ROSTENKOWSKI. Thank you, Mr. Gordon.

[The prepared statement follows:]

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STATEMENT OF ARTHUR I. GORDON, PRESIDENT-ELECT, NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

My name is Arthur I. Gordon, President Elect of the 33,000 member New York State Society of CPAs. With me is Janice M. Johnson, the Society's Director of Tax Policy. Thank you for having us appear before you today.

Based on our profession's deep involvement in the financial affairs of millions of individual and business taxpayers in their offices and on their factory floors, we possess a unique micro economic perspective that few others have. This enables CPAs, perhaps more than any other group, to understand how taxpayers will react to the impact of specific tax proposals.

While some will refer to the tax changes you are about to enact as a "relief act" for CPAs and attorneys, we have been on record in the past, and go on record today, as opponents of tax complexity. With our limited time here today, we cannot comment on all of the provisions; however, we believe that they should be made as simple as possible within the framework of achieving the objectives of economic stimulus and tax equity.

We are especially concerned that the benefit of certain provisions, intended to stimulate investment and economic growth, such as the investment tax credit provisions with built-in sunsets, will be outweighed by the cost and inconvenience of administrative complexity.

INVESTMENT TAX CREDIT

The ITC should be available to all businesses, not just manufacturing and technology. It is unclear to us from the drafts of the proposals that we have seen whether this is intended. Furthermore, in order for businesses to plan, a permanent ITC for both large and small businesses is desirable. Finally, enacting an incremental credit punishes those businesses that continued to invest during the recession. This seems an unfair result to us.

REAL ESTATE PROVISIONS

The Society generally supports the provisions, as we believe that the passive loss rule should not have been applied to active real estate professionals and that the proposed remedy is long overdue.

CHARITABLE GIFTS OF APPRECIATED PROPERTY

We support the exclusion from the AMT preference for the contribution of appreciated property. We assume that this exclusion will apply to all gifts of property after 1992 -- including securities and real estate. We believe that for purposes of simplicity and fairness, this should be the case. The tax law can stimulate or retard vital activities, such as maintaining educational and cultural institutions. This provision proved to be a very effective stimulus for such institutions and it should be reinstated and expanded.

SELF EMPLOYED HEALTH INSURANCE DEDUCTION

We agree with Congressmen Grandy and Brewster and Senator Dorgan that the health insurance deduction for the self employed should provide parity with corporate business and should be made permanent. Such legislation would benefit farmers, entrepreneurs and, yes, accountants and attorneys.

However, making the amendment retroactive to July 1, 1992 could unduly complicate the filing of 1992 tax returns. Therefore, we would not oppose making the provision applicable to years beginning in 1993. We assume that it is only effective through 1993 with the intention that the comprehensive health care reform bill will address this issue for payments made in later years.

INCREASED INDIVIDUAL TAX RATES

We generally support the need for an increase in individual tax rates to help reduce the deficit. As CPAs, we do not contend that a particular rate is right or wrong; however, we do favor open and honest rate adjustments to raise or lower revenues rather than hidden "floors", "ceilings", "percentage disallowances" and other mechanisms designed to hide the actual result of a tax increase.

Accordingly, we favor a fifth rate, rather than a maximum rate plus a stated surcharge.

It is important to realize that there is a huge difference in changing tax rates today as opposed to pre-1986 when there were many credits and deductions available to cushion an increase in rates. We have some concern about the difference the rate increase has based on geographic location. Clearly, a married couple filing a joint return at the proposed applicable 36% threshold of $140,000 has a very different standard of living in New York City, Los Angeles or Washington compared to Syracuse or Topeka, but we think the thresholds for imposing maximum rates are moving in the right direction.

DISALLOWANCE OF VARIOUS ORDINARY AND NECESSARY BUSINESS EXPENSES

The proposal calls for limitation and disallowance of a number of ordinary and necessary business expenses which currently meet the tests of Internal Revenue Code Sections 162, 212, etc. As a matter of economic and tax policy, we do not believe that businesses should be hindered by the tax law in our global economy from making spending decisions.

While many are concerned with the growth of executive compensation, the overuse of expense accounts and other perceived excesses in our economy, we believe that the free market is the best way to sort these problems out. For example, from the time that the provision concerning executive compensation was initially proposed, there have been major changes in corporate boardrooms throughout the United States directed toward this problem.

The proposal to disallow lobbying expenses impacts across the economy -- now the small businessman paying his attorney a retainer to represent his interests legislatively, as well as legally, is swept into these rules. The rule would require complex allocations to determine what actually constitutes lobbying.

If Congress feels that lobbying expenses, in general, should be nondeductible, it should provide a de minimis rule; perhaps excluding from the definition of lobbying, expenditures which are 10% or less of total expenses.

This de minimis relief would also benefit professional associations, such as the New York State Society of CPAs, which primarily exist to educate members and provide technical assistance to legislative bodies but who do spend a small amount of their resources on true lobbying.

COMPLIANCE INITIATIVES

We oppose the measures related to penalties. Just a few years ago, Congress passed the Improved Penalty Administration and Compliance Tax Act. The Act was the product of an unprecedented collegial process, initiated by Congressman Pickle, between the tax writing committees, the IRS, the accounting profession, the Bar and other interested parties.

In our view, the current proposal is the type of tinkering which has crippled penalty provisions in the past and would lead to reduced rather than improved compliance.

CAPITAL GAINS

We feel that any capital gains relief should be targeted, such as it is in these proposals to small business. However, the limitations contained in these proposals, to investments of the greater of $1 million or 10 times the investment, add complexity and do not encourage venture capitalists to invest substantial sums in small businesses. The overall definitions of "small business" and "related businesses" should be enough to curb abuses in this area.

The Society is currently developing a more detailed commentary

on these proposals which will be forthcoming in the following weeks. We clearly recognize and support the need for the federal government to increase tax rates to reduce the deficit and contain costs, but we also believe that tax complexity in itself is a drag on our economy and that any tax measures to achieve these ends should be made as simple as possible and should be aimed at reducing the cost of compliance.

Thank you again for inviting us here today and we would be glad to answer any questions you may have.

A greatly condensed version of the 85 pages of detailed comments submitted by the New York State Society of CPAs follows. The full written comments address all of the President's proposals as well as make suggestions concerning two additional issues: the taxation of household workers and workload compression (IRC Section 444).

Introduction

The New York State Society of Certified Public Accountants (NYSSCPA) is the largest accounting organization in the nation representing the CPAs of a specific state. NYSSCPA membership numbers in excess of 33,000 CPAs. Our members practice in all sizes of firms and represent all types of clients in planning their business transactions and in calculating their tax liabilities. As a result, our members are able to provide enormous insight into the likely behavior of business and individual taxpayers in response to proposed changes in the tax law.

History--the 1986 Tax Reform Act

The truth of this assertion was demonstrated in 1985, when the Society submitted comments on President Reagan's tax proposals for "Fairness, Growth and Simplicity." In our analysis, we stated our fear that, "Average taxpayers will be bombarded with stories of the large tax savings of the wealthy, compared with their minor savings under the President's plan." We went on to state, "The use of the Tax Code to achieve economic and social aims has strongly influenced the structures of business and of investment patterns in this country....Repeal of current incentives will disturb these structures, perhaps seriously." The analysis listed those individuals and entities whose activities we felt would face at least some disruption. Included in this list were:

Real estate syndicators, mortgage bankers, builders and others aided by various real estate incentives;

State and local governments forced to find new sources of revenue or make hard choices concerning decreased services;

Capital intensive industries dependent on ACRS and the investment credit; and

Banks, insurance companies and other entities whose operations could be profoundly affected by the proposals.

We feel that our comments concerning the 1985 tax proposals were on the mark in many instances and that much of the negative effect of the 1985 proposals might have been avoided had they been recrafted to take into consideration analyses such as ours. We, as well as many others, believe the decline in the real estate market can be attributed in large measure to the changes in the passive loss rules enacted in 1986. This decline in real estate, in turn, seems to have lead to financial difficulties in the savings and loans and in the insurance industry. It is possible that much of our economic slump of the last few years may be traceable to the 1986 tax law changes. It is our hope that comments made concerning President Clinton's proposals will be weighed carefully to avoid the economic disruption generated by the 1986 Tax Act.

Simplification of the Tax Law

Any tax law changes that are enacted this year should be drafted to be as simple as possible. If the current tax law is not simplified, and any changes made to it made as simple as possible, our tax system is likely to eventually fall under its own weight. It is important to always remember that ours is a voluntary compliance system, and unless people understand the tax law and feel that it is reasonable and fair, many may begin to perceive that fully complying with it is not worth the effort.

Every time there have been tax law changes enacted in recent years, these changes have been referred to as "Accountants' and Lawyers' Relief Acts." While this generates chuckles and more than a few nods of agreement from the clients of tax professionals who are forced to pay increased fees, the reality is that the increased complexity of the tax law and the pace of the change have enormously eroded the profitability of most tax practices. Each tax law change requires many hours of training tax staff and of revising tax practice procedures. Additionally, in recent years many tax changes have been rather far-reaching, not necessarily grounded in sound tax policy but, rather, means of achieving revenue neutrality without government's being forced into admitting a tax rate increase is necessary.

These kinds of changes require substantial amounts of additional time to complete a tax return, and this frustrates both taxpayers and tax professionals. Often there is simply more paper to file and more taxes to pay, while the government keeps making assurances that there has not been a tax rate increase. This is a confusing situation at best and one that adversely affects tax practices and tax administration.

"Back-Door" Revenue Raising

It does seem fairly clear to us that a tax rate increase may be necessary to raise significant amounts of revenue to reduce the deficit. The maximum tax rates were probably reduced too much in 1986, since spending was not correspondingly reduced, resulting in the mushrooming of the deficit.

However, we would like to urge that Congress keep in mind that many deductions were eliminated or capped in 1986, thereby substantially diminishing the benefit of the tax rate cuts for many middle income Americans in particular. Eliminating deductions generally serves to simplify the tax code, certainly an end which we applaud. However, eliminating deductions for taxpayers who have made investment decisions, at least partly hinging on the tax law, serves to erode taxpayers' trust in the tax law and their respect for it. Thus, the imposition of the passive loss rules (albeit on a phased-in basis) on taxpayers who were able to afford the investment in certain pieces of real estate only because of the tax benefits these properties provided, permanently harmed many of these Americans economically. There have been numerous personal bankruptcies, as well as business failures, as a result of the 1986 tax law changes. The goal of eliminating tax shelters was a laudable one, but it should have been achieved in a more gradual fashion, in order to cause less economic pain. In the future, any tax legislation should seek to avoid such economic disruption by only applying to prospective transactions.

Furthermore, rather than putting limits on deductions that are otherwise allowable under the tax code, Congress should be more honest with the American people and, if the revenue is really a necessity, raise the tax rates. This makes the tax code much easier to work with and it gives taxpayers a clearer picture of the true rate of tax they are paying.

A Value Added Tax

As for considering some type of value added tax, Congress should recognize that while it may be a relatively painless way to raise vast amounts of money while leaving income tax rates untouched, it is again a fairly dishonest way of dealing with the American people. Congress would be able to point with pride to the fact that it had not fiddled with the income tax rates--or was perhaps even able to lower them. However, imposition of such a new and regressive tax would create a vast new bureaucracy which would be expensive to establish and maintain. Furthermore, once such a taxing scheme is in place, it would become as easy to raise its rates as it was in the early days of the income tax so that soon the U.S. VAT rate could approach that of Great Britain. Instead of providing a new form of temptation for increasing spending, Congress should start making hard choices under our current system as to where spending cuts can be made and programs curtailed.

President Clinton's Goals

We do feel it is necessary to make a general observation concerning many of the tax proposals which have been presented to Congress by President Clinton. They seem designed to foster a segment of the American economy which may not be the most fruitful target for stimulation. Many of the proposals seem to be geared primarily at encouraging small manufacturing enterprises. Once upon a time America had a number of small, "mom and pop" manufacturing concerns. They were located throughout many American communities.

However, in recent years, we have become a nation of service businesses and large manufacturing conglomerates. Some small manufacturing exists today, but, in large part, we do not see our clients starting up these kind of businesses. Many of our international competitors are huge undertakings benefiting from government subsidies and the economies of scale of large conglomerates--as well as benefiting from the cost savings available to multi-national operations. It may well be impractical for a primary target of stimulation of the American tax law to be new small manufacturing enterprises which, in today's global economy, can be inefficient and noncompetitive. Thus, we feel small manufacturing should be encouraged, but it is unrealistic to think that this alone can reverse the decline in our economic fortunes.

The New York State Society of Certified Public Accountants will be pleased to explain or to discuss further any of the points touched on above or discussed in our following detailed analysis of specific provisions.

SPECIFIC PROVISIONS

Investment Tax Credit

Position

We believe there may be easier and more effective ways to encourage investment in new plant and equipment than through an investment tax credit. This is particularly true if the credit is to be incremental, thereby favoring those businesses that were unwilling or unable to invest during the prior uncertain years in our economy and punishing those that went ahead and took the plunge. Furthermore, any credit that is not made permanent makes it difficult for businesses to plan their investments and spread them over a period of years in an organized, well thought-out fashion. Additionally, the credit, as proposed, appears to favor small manufacturing and technology concerns at the expense of certain service businesses and large conglomerates, a result we do not think is desirable.

These problems can be addressed by not targeting the credit at either small business, certain types of businesses or incremental investments. Although the pre-1986 Act credit was quite complex, if the stimulus of a credit is deemed essential, we would favor

following its approach.

Analysis

For businesses paying tax at a lower rate, a credit is more valuable than a deduction or exclusion. Thus, by its nature the investment tax credit benefits small businesses. The current proposal would go further and only make the credit permanent for smaller enterprises, but, even then, at a reduced rate. Apparently, it may not even apply to service businesses for their purchases of furniture or to the purchase of restaurant equipment and the like. This does not appear to take into consideration the realities of the current business mix in the U.S., our global economy and the way businesses are run today.

Any credit that is provided should be allowed to all businesses and on some type of permanent basis. We have a real need to shore up our service businesses which, upon their start-up, create a number of the new jobs in this country. More and more small accounting, law, advertising firms and the like are being formed as larger concerns become less profitable and more top-heavy. These new operations should be able to benefit from any credit that is available.

Alternatively, our large airplane, automobile, electronics and computer manufacturers are finding it harder and harder to compete either overseas or even within our own shores. Any credit that is not available to these operations on the same basis that it is available to other enterprises--and on a permanent basis--is not targeted to take into account the reality of today's business climate. Any small manufacturers who wish to start up should be encouraged by our tax law, but they do not appear to be the wave of the future as it becomes more costly to establish such businesses and to purchase the necessary equipment to compete in any meaningful way.

The incremental nature of the credit would dramatically increase complexity. Measuring base period investments would, in many cases, require burdensome research to identify the types of investments included in the base period calculation.

In addition, it is not clear that any credit would be available for purchasing rebuilt assets, such as airplanes or boats. In fact, the proposal makes it clear that the credit would not be available for the purchase of used equipment. Another fact of life in today's economy is that much of the equipment used in businesses is too costly to purchase new and may be even better if rebuilt than purchased new. Also, due to environmental and conservation concerns, we should generally be encouraging the rebuilding of equipment wherever possible. Thus, we feel that the law should distinguish between rebuilt and used equipment and specify that the credit is available for rebuilt assets.

The small business credit would not be available to businesses having gross receipts of more than $5 million. Thus, a business with $5,000,001 in gross receipts would be ineligible. Although a phased-out definition of small business would add complexity, such an amendment seems necessary to make the proposal fair.

Finally, the amount of the credit which is proposed would be fairly insignificant to stimulate certain investments. For three year property, the amount of the credit would only be 2.33 percent during the years in which a 7 percent credit was available to small businesses. After two years, when the credit fell to 5 percent, the credit for three year property would be only 1.67 percent. Such a small benefit does not seem to justify the additional administrative complexity that would be added. Furthermore, to generate more immediate stimulus from the credit, the carryback of unused credits to years prior to the effective date of the legislation should be allowed.

It may be that concentration on making long-term, low cost loans available to all businesses for the purchase of plant, equipment, furniture and other business assets would be a much more effective, lower cost solution to achieve the retooling of existing manufacturing concerns and the start-up of new small businesses, the creators of the greatest amount of new jobs. If a government program could be developed to encourage lenders to provide funds for this purpose, either through tax or some other incentives, it seems that it could substantially stimulate business investment in capital assets.

Permanent Extension of R&E Credit

Position

There should be government support of research and experimentation efforts. However, a tax credit does not seem to provide the necessary impetus. We strongly urge that a new means of promoting research efforts be found--particularly for start-ups.

Analysis

For many businesses that are starting up, a tax credit will provide very little benefit since the start-up may have no taxable income and, therefore, no tax liability for the credit to offset. Furthermore, the credit is tremendously complicated to calculate and the start-up will find itself incurring large professional fees to determine a credit that is of no current benefit. The proposed modifications to the credit seem to only exacerbate this problem for newer businesses. They add still more calculations that the business must make, again at a time when the business may have no tax liability for the credit to offset.

This credit is also very difficult to calculate due to the vagueness of the definition of qualified research expense. This vagueness has lead to many disputes between taxpayers and the IRS. We recognize that it may not be possible to more specifically define the term qualified research expense. However, this may be an area for Congress to make available non-traditional dispute resolution techniques.

More available government research grants and less costly loans to fund research could be the answer. These possibilities are certainly less complex. Again, the government could establish programs to encourage lenders to provide low-cost funds for research programs. Full deductibility of research and experimentation expenses, even in the start-up phase of a business, could also provide significant benefits in a less complicated manner than the credit.

It adds to complexity that the same research expenditures can also be used, at least to some extent, to calculate deductions. If expenses do qualify for the credit, perhaps the rate of the credit should be increased to something more than the maximum tax rate, and the deductibility of the expenses should be disallowed.

Once again, rather than requiring the amendment of 1992 returns, if a credit is enacted, effective as of July 1, 1992, the taxpayer should be allowed to include any benefits from it in the 1993 return.

Capital Gains Exclusion for Certain Small Business Stock

Position

We favor a targeted capital gains provision, such as this, to encourage very specific economic behavior. It seems to us to be more cost-effective than across-the-board cuts in capital gains rates. However, we feel that too many restrictions have been put on the availability of this benefit.

Analysis

There is an overall limit in this proposal that the capital gains

exclusion would only be available to investors in certain types of businesses with aggregate capitalization of less than $25 million from January 1, 1993, where the investment was held more than five years. It seems to us that these restrictions alone are enough to foreclose most abuses.

Once the excludable amount is also limited to the greater of $1 million or ten times the investment, many venture capitalists, the very investors most likely to aid many small businesses, will find very little in this provision to interest them. It will not serve as much of an incentive to encourage investment, and the venture capital investor will continue to make his or her investment decisions regardless of this provision. If the only limitation were the higher limit of the $25 million in total capitalization, the provision should become much more attractive to this type of investor.

AMT Treatment of Gifts of Appreciated Property

Position

We support the exclusion from the alternative minimum tax (AMT) preference for charitable contributions of appreciated property.

Analysis

From the currently available drafts of the proposal, however, it is unclear whether the exclusion would apply only to gifts of appreciated tangible personal property or, more broadly, as it appears to be drafted, to gifts of all personal property, which would then include charitable gifts of stocks, bonds and other securities.

If the proposal is already this broad, it seems to us that it should apply to charitable gifts of appreciated real estate as well. Once its scope extends beyond gifts which are strictly for the use of a charitable organization, such as gifts of paintings to an art museum, for purposes of simplicity and fairness it should include gifts of all property, both personal and real.

The tax law can stimulate or retard vital activities, such as maintaining educational and cultural institutions. This provision proved to be a very effective stimulus for prompting gifts to such institutions, and it should be reinstated and expanded.

Self-Employed Health Insurance Deduction

Position

We believe that the health insurance deduction for the self-employed should provide parity with the deduction allowed to corporate businesses and should be made permanent. Such legislation would benefit farmers, entrepreneurs, accountants, attorneys and other professionals, and tradespeople, as well as the owner/employees of S corporations.

Analysis

Absent this provision, a disparity is created between the tax treatment of owners of incorporated and unincorporated businesses (e.g., sole proprietorships, partnerships and, in this case, S corporations). An incorporated business can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for its employees, including owner-employees. By contrast, a self-employed individual operating through an unincorporated business, or a more than 2 percent shareholder in an S corporation, can only deduct the cost of health insurance for himself and his dependents to the extent that it exceeds 7.5 percent of adjusted gross income.

Prior to July 1, 1992, mainly as a vestige of Section 89 which never became effective, a self-employed individual was allowed to deduct as other than an itemized deduction up to 25 percent of the amount paid for health insurance coverage for himself, his spouse

and his dependents. The proposal would reinstate this partial deduction from July 1, 1992, through December 31, 1993. Instead of making taxpayers amend 1992 tax returns to take advantage of it, we suggest that they simply be allowed to include the deduction for the whole 18-month period in their 1993 returns. This would dramatically simplify their filing burdens, while delaying the revenue cost of this provision to the Treasury and not substantially harming the taxpayer financially.

We have always been sensitive to distinctions created in the tax law between incorporated and unincorporated entities. Since 1982, with the exception of a few provisions, the rules governing qualified pension plans have created parity. We believe that the rules regarding health plans should also be reevaluated in order to eliminate major distinctions. This is particularly true in light of the dramatically increasing cost of health insurance.

We assume that this provision is drafted to be effective only through 1993 with the intention that the comprehensive health care reform bill will address this issue for payments made in later years. We urge the Administration to create parity as part of its health care reform package. We do not see any rational reason for establishing preferential treatment for health insurance coverage for a specific form of doing business. A decision as to the form of entity in which a business should operate should be made based on tax and non-tax issues other than this.

Assuming any health care reform package will contain changes in the rules regarding the deductibility of health insurance premiums, and knowing that such major changes could take a considerable time to be enacted into law, we urge that this provision be extended permanently. Then, if this particular set of rules is not addressed legislatively prior to December 31, 1993, we will not find ourselves yet again in the situation of needing to legislate an extension in the application of these rules.

Increased Tax Rates for Higher Income Individuals

Position

We generally support the need for an increase in individual tax rates to help reduce the deficit. As CPAs, we do not contend that a particular rate is right or wrong; however, we do favor open and honest rate adjustments to raise revenues, when needed, rather than hidden revenue increases, such as "floors," "ceilings," "percentage disallowances" and other mechanisms designed to disguise the fact that there has been a tax increase. Accordingly, we favor a fifth rate, rather than a maximum rate of 36 percent plus a stated surcharge. We do believe that the $250,000 threshold for the surcharge is set at too low a level.

Analysis

It is important to realize, however, that when tax rates are increased today, the rate increase is much more significant than it was pre-1986 when there were many credits and deductions available to cushion an increase in rates.

We are also concerned that the brackets at which the maximum tax rate will apply are often set much too low for those taxpayers living in high income, high cost urban areas. Clearly, a married couple filing a joint return that has $140,000 in taxable income has a very different standard of living in New York City, Los Angeles or Washington, D.C., compared to what they would have at this income level in Syracuse or Topeka. We think the cut-offs proposed by this Administration are more realistic than those which have been enacted in the last few tax laws. However, we would like to see more attention given to the discrepancies in the costs of living in the various areas of the U.S. It should be possible to come up with a way of graduating tax rates based on where a taxpayer lives, similar to the concept the IRS uses in fixing its per diem travel expense allowances for various metropolitan areas.

We would also recommend that Congress reinstate full deductibility of itemized deductions and personal exemptions, even if this means a slight additional increase in the maximum individual tax rates. It is much more difficult for taxpayers to accurately predict their tax liabilities when it is necessary to factor in these phase outs.

Reduce Deductible Portion of Business Meals and Entertainment

Position

We strongly oppose the current disallowance of 20 percent of the deduction for business meals and entertainment. We think increasing the nondeductible amount to 50 percent is very bad tax policy.

Analysis

The disallowance of legitimate business deductions is simply a hidden tax increase--something we have indicated several times that we greatly oppose. We feel that Congress should be honest with the American people as to the true tax rate which is imposed on them. Furthermore, we think it is bad economic and tax policy for businesses to be hindered in their spending decisions by the tax law. Additionally, disallowance provisions, such as this one, add substantial complexity to the tax law.

This proposal also does not take into account that different sizes and types of businesses operate differently. Big businesses create goodwill primarily through institutional advertising while small businesses spend much more, proportionally, on business entertaining to create goodwill with existing customers and to woo new ones. Since small businesses are the greatest creators of new jobs in our economy, our tax law should serve to encourage their efficient operation. Proposals such as this one have the opposite effect--increasing recordkeeping burdens, accounting fees and tax bills.

Further, this increase in the limitation will have the effect of curtailing entertaining at restaurants, resulting in decreased revenues, leading to less income tax revenues, less local sales tax revenues, and less employment.

Deny Deduction for Club Dues

Position

We also oppose disallowance of this deduction.

Analysis

In many communities, the accepted way of building customer relations is through entertaining at clubs--especially for the smaller business. In certain towns across America, big companies have corporate dining rooms on the premises. Other businesses must either use the country club or the local diner to entertain their business contacts. Therefore, the club dues a company pays are often business necessities. Disallowing such deductions again makes it harder for businesses to conduct their affairs in a manner that makes sense, given today's life styles. Certain clubs provide the right atmosphere to engage in serious business discussions to a much greater extent than any office setting or restaurant. Furthermore, at a golf, tennis or exercise club, it is possible to establish a different level of business camaraderie than it is in an office setting.

Our tax law should be structured to encourage the efficient and profitable operation of businesses. The more profitable they are, the more tax revenues that will be collected. If club membership contributes to this end, it should be favored by the tax law instead of resulting in one more hidden tax increase.

It is important to keep in mind that the law already requires that more than 50 percent of the business use of the club be proved before any portion of the club dues are deductible.

Require Securities Dealers to Mark to Market

Position

While we recognize that this is the way business is actually conducted in the securities industry, we do not support the idea that taxable income should be accelerated through mark-to-market concepts.

Analysis

Even though requiring securities dealers to mark their inventories of securities to market will currently result in additional taxable income since the securities markets are strong, the Treasury must understand that some day this provision could actually be a revenue loser, if the markets decline dramatically. Furthermore, the income required to be recognized by a securities firm under this proposal could well disappear in the succeeding taxable year. The only time such a mark-to-market concept has been applied previously in the tax law is with respect to regulated futures contracts. And this was in exchange for favorable capital gains treatment of these contracts.

It does seem to us that Congress should now deal with the problems presented in the financial industry by the Arkansas Best decision. While the mark to market proposal takes into account the way the securities industry actually operates, so should other provisions of the tax law. In the global economy of today, there are enormous amounts of hedging of currency and interest rate fluctuations. This is no more than prudent business practice. If there are losses in these hedging positions, the losses should not be deemed capital but should, instead, be treated by the tax code as ordinary business deductions. This is not necessarily the conclusion the IRS will reach after Arkansas Best. There is a real need for clarification of the tax law in this area.

If it were necessary for Congress to specifically require marking to market of securities dealers' inventories in exchange for relief from Arkansas Best, we could support such a trade-off.

[The document in its entirety has been retained in the Committee fi

Chairman ROSTENKOWSKI. Mr. Murphy.

STATEMENT OF MICHAEL J. MURPHY, EXECUTIVE DIRECTOR, TAX EXECUTIVES INSTITUTE, INC.

Mr. MURPHY. Thank you, Mr. Chairman. I am Mike Murphy, the executive director of Tax Executives Institute, or TEI. This marks my first appearance before the committee since I retired as the IRS Deputy Commissioner a year ago, and I am pleased to present TEI's views on the President's tax proposals. I am accompanied by Timothy McCormally, the institute's general counsel and director of tax affairs.

Before going further, Mr. Chairman, I want to congratulate you and members of the committee for holding these hearings and allowing a mix of views to be presented. Also, since you have O'Neill leading off and Murphy batting fourth, with McCormally leading interference, I guess I am the one that should wish you all a very happy St. Patrick's Day.

TEI is the principal organization of the corporate tax professionals in North America. Our approximately 4,800 members represent more than 2,300 of the leading corporations in the United States and Canada. As a broad-based organization, TEI frequently finds itself unable to take positions on major policy issues that come before the committee. For example, the institute has historically declined to take a position on proposed changes in the tax rates and balancing them with possible changes in the tax base. Similarly, because of its disparate effect on various segments of our membership, TEI has to date chosen not to take a formal position on the proposal to reinstate the investment tax credit.

Our written statement contains detailed comments about the specific proposals in the President's package. In my comments this morning, I want to highlight a number of concerns raised by the administration's proposals. First, we believe that the President's package as a whole asks a fundamental question about the state of the "compact" that was reached between taxpayers and the Government when the Tax Reform Act of 1986 was enacted. At that time the tax base was broadened and several tax incentives were eliminated in exchange for a lowering of the rates and generally simpler individual tax system. One of the promised consequences, as you well know, was stability—something that is absolutely essential to business. Of course, the business community paid a price through higher taxes for the promised stability.

Regrettably, that stability was extraordinarily short-lived. Now, the President proposes to increase both corporate and individual tax rates, to reinstate incentives such as the investment tax credit, and to enact a number of provisions that would further complicate the law, require the expenditures of large amounts of money on nonproductive activity, and impair America's ability to compete effectively abroad.

TEI does not deny the right, even the obligation of the administration and Congress to fine tune the Internal Revenue Code and to adapt to changing conditions. In proposing to make certain provisions permanent—including the targeted jobs credit, the research tax credit, and the exclusion for employer-provided educational assistance—we believe the administration has moved in the right di-

rection. Specifically, it has sought to remedy the on again-off again nature of these provisions.

We do believe, however, that more than lip service must be paid to the goals of stability and simplification. Other speakers have mentioned this same point. They have also mentioned that other provisions of the President's plan violate all notions of stability, simplicity, and good tax policy. I would like to comment on three proposals.

First, we believe the President's proposals to disallow or curtail deductions for legitimate business expenses deviate from what should be a fundamental precept of the tax system—that people are not taxed on gross receipts, but on income. Stated differently, the 16th amendment authorizes a net income tax system in which deductions are generally allowed for the expenses of generating that income. The President's proposal would stray from that concept, for example, by disallowing a deduction for lobbying and arbitrarily capping the deduction on executive compensation.

TEI questions whether these changes would significantly change how business is conducted. Businesses will continue to communicate their views on proposed legislation when it is in their or their shareholders' best interests and will, if the market demands it, pay their executives in excess of a million dollars. We believe, however, that the proposal ignores the fact that we operate in a global economy. Whenever the cost of doing business in the U.S. increases, either through a denial of a deduction or the imposition of additional compliance costs, then the competitive position of the country as a whole is going to suffer.

In addition, with respect to the lobbying deduction, the proposal could have the effect of deterring people from communicating their legitimate concerns about legislation. The need for such communication is obvious. Consider, for example, section 89 or, more recently, the luxury excise tax. If the affected constituency is silenced, problems of both policy and administration are likely to arise.

Second, the international proposals in the President's package would add unnecessary complexity to the Code and thereby diminish the ability of U.S. businesses to compete abroad. For example, the proposal to currently tax certain accumulations of foreign earnings states that a change is needed to prevent excessive accumulation of foreign earnings. There are, however, already two overlapping sets of antideferral rules. One is subpart F, which was enacted in 1962 and the second relating to passive foreign investment companies, was enacted in 1986. These proposals have the same intent to end deferral on tax on passive assets, which is what the President is proposing to do.

In other words, in terms of tax policy we think there is a redundancy. We have similar concerns about the effect of the proposal to treat royalties as passive income.

Finally, Mr. Chairman, one of the proposals seeks to transfer the responsibility for and the expense of insuring compliance with certain tax laws from the IRS to the already compliant taxpayer. I am referring to the proposal to require the filing of information returns—form 1099—on all payments for services in excess of $600, including the payments to corporations. This proposed mandate to

file information returns on payments to corporate service providers is not something that can be accomplished cost free.

Indeed, given the Joint Committee on Taxation's revenue estimate of $326 million—compared to the administration's proposal of $6.35 billion—TEI believes there is a good chance that the cost of the payer community would exceed the revenues that would be flowing into the Treasury. More than one company, Mr. Chairman, has told us that it would exceed $1 million just to implement the proposed changes and nearly that much to maintain the system on an ongoing basis. Equally important, there is no convincing evidence that the IRS could process the millions of additional returns generated under this proposal.

Mr. Chairman, there are several other things that I could cover, but in the interest of time I will close now, but I would like to again thank you for giving us this opportunity to testify.

[The prepared statement follows:]

STATEMENT

of

TAX EXECUTIVES INSTITUTE, INC.

on

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

submitted to

Committee on Ways and Means
U.S. House of Representatives

March 17, 1993

Mr. Chairman and Members of the Committee: I am Michael J. Murphy, Executive Director of Tax Executives Institute, and I am pleased to present the Institute's views on the President's Proposals for Public Investment and Deficit Reduction. I am accompanied today by Timothy J. McCormally, the Institute's General Counsel and Director of Tax Affairs.

Background

Tax Executives Institute is the principal organization of corporate tax professionals in North America. Our approximately 4,800 members represent more than 2,400 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. TEI is firmly committed to maintaining a tax system that works — one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the IRS can effectively perform its audit function.

Mr. Chairman, TEI applauds the Committee's decision to hold these hearings in order to obtain preliminary comments on the President's tax proposals. TEI is also pleased with the emerging consensus in both the Administration and the Congress to forge a strong and coherent economic package to reduce the deficit, to cut unnecessary government spending, to create jobs, and to otherwise stimulate the economy. The question, of course, is how best to achieve these laudable goals.

A principal challenge in analyzing the President's proposals — especially for tax executives whose mission is to divine how they may affect their companies — is that the specifics of the proposals are in many respects "moving targets." Legislative language has not yet been released, and indeed, some provisions remain undefined or seem to change on a day-to-day basis. The lack of specificity is unfortunate because operational problems with tax proposals frequently are not discovered until the statutory language can be parsed and appraised by those who will have to live with it. In other words, since the details of many of the President's proposals have not yet been released, our comments will of necessity be somewhat tentative. Please be assured that we shall supplement our comments as the legislative process moves forward.

General Comments on the President's Proposals

As a broad-based organization, TEI frequently finds itself unable to take positions on major policy issues that come before the Committee. Our diversity thus limits our ability to opine on certain major policy initiatives. For example, the Institute has historically declined to take a position on proposed changes in the tax rate and to balance such proposals with possible changes in the tax

base. Similarly, because of its disparate effect on various segments of our membership, TEI has to date chosen not to take a formal position on the proposal to reinstate the investment tax credit.

We do wish to note, however, that the President's proposals ask a fundamental question about the state of the "compact" that was reached between the government and taxpayers seven years ago when the Tax Reform Act of 1986 became law. At that time, the tax base was broadened and several tax incentives were eliminated in exchange for a lowering of the rates and a generally simpler tax system (especially for individuals). One of the promised consequences was *stability* — something that is absolutely essential to business. To plan, one has to know what the rules are and what they will be. Of course, there was a price that the business community had to pay for the promised stability: although the 1986 Act was revenue neutral overall, it exacted $120 billion in additional taxes over five years from the corporate community and imposed compliance burdens out of all proportion to the tax policies supposedly served by the underlying statutory provisions.

Regrettably, the stability that was promised to taxpayers was extraordinarily short-lived. First, in 1988, again in 1989, and most recently in 1990, Congress and the Administration chipped away at the bargain that was struck in 1986. Tax rates were not directly increased in those earlier bills, but business taxpayers were saddled with a large number of complicated tax increases, which required the expenditure of both time and money to understand and implement. Now, the President proposes to increase both corporate and individual tax rates, to reinstate incentives such as the investment tax credit, and to enact a number of provisions that would further complicate the law, require the expenditure of large amounts of money on nonproductive activity, impair America's ability to compete effectively abroad, and arguably spur a resurgence of tax shelters and other uneconomic activities.

TEI does not deny the right — even obligation — of the Administration and Congress to fine-tune the Internal Revenue Code and to adapt to changing conditions. We do believe, however, that more than lip service must be paid to the goals of stability and simplification. In proposing to make certain provisions permanent — including the targeted jobs credit, the research tax credit, and the exclusion for employer-provided educational assistance — we believe the Administration has moved in the right direction. Specifically, it has sought to remedy the on-again, off-again nature of these provisions and to inject some modicum of certainty into the tax system.

In stark contrast, other provisions of the President's plan would violate all notions of stability, simplicity, and good tax policy. First, we believe the President's proposals to disallow or curtail deductions for legitimate business expenses deviate from what should be a fundamental precept of the tax system: that people are taxed not on gross receipts but on *income*. Stated differently, the Sixteenth Amendment authorizes a *net* income tax system in which deductions are generally allowed for the expenses of generating income. The President's proposals would stray from that concept, for example, by disallowing a deduction for lobbying expenses and arbitrarily capping the deduction on executive compensation. TEI questions whether these changes would significantly change how business is conducted: businesses will continue to communicate their views on proposed legislation when it is in their or their shareholders' best interests and will — if the market demands it — pay their executives in excess of $1 million. A cynic might say, if behavior will not change, is this not a good way to raise revenue? Leaving aside the question of principle, what that argument ignores is that we operate in a global economy. Whenever the cost of doing business in the United States increases (because a deduction is denied or an additional compliance cost is imposed), the competitive position of the country as a whole cannot be helped.

Second, the international proposals in the President's package would add unnecessary complexity to the Internal Revenue Code and thereby diminish the ability of U.S. business to effectively compete abroad. Consider, for example, the proposal to tax in advance of repatriation to the United States certain accumulations of foreign earnings deemed to be "excessive." The proposal states that a change is needed to prevent the "excessive accumulation" of foreign earnings. There are, however, already two overlapping sets of anti-deferral rules — one that was enacted in 1962 called Subpart F and the second, relating to "passive foreign investment companies" (PFICs), which was enacted in 1986 to do the very thing the President's proposal is intended to do: end the deferral of tax on passive assets. In other words, in terms of tax policy, the proposal is redundant. In terms of tax administration, it is tremendously complicated. Rather than end the redundancy and streamline the law, the President's proposal would add another layer of rules and another layer of costs and, we submit, garner very little revenue for the government.

Finally, one of the proposals seeks to transfer responsibility for — and the expense of — ensuring compliance with certain tax laws from the IRS to already compliant taxpayers. We refer

to the proposal to require the filing of information returns — Forms 1099 — on all payments for services in excess of $600, including payments to corporations. (Currently, Forms 1099 need not be filed in respect of payments to corporations, in part because the filing of such returns would flood the IRS with information that it could not use.) This proposed "mandate" to file information returns on payments to corporate service providers, however, is not something that can be accomplished cost free. Indeed, given the Joint Committee on Taxation's revenue estimate for the proposal — $326 million (as opposed to the Administration's $6.35 billion estimate) — TEI believes there is a good chance that the cost to the payer community would exceed the revenues flowing to the Treasury. More than one company has already estimated its costs would exceed $1 million to implement the proposed changes and nearly that much to maintain the new system on an ongoing basis. Equally important, there continues to be no convincing evidence that the IRS would be able to process the millions of additional pieces of paper that would be generated under the proposal. In this regard, it is interesting to note that one aspect of the proposal — an IRS initiative to assist payers in verifying the taxpayer identification number of payees — has been abandoned, apparently because the IRS cannot implement the program on schedule. There is no similar sympathy demonstrated, however, for the payers that would have to modify their computer systems, institute manual processes, and otherwise gear up for the information reporting program.

In the ensuing sections of this statement, TEI sets forth its views on specific proposals contained in the President's economic package.

Limitations on the Deductibility of Ordinary and Necessary Business Expenses

A. *Limitations on the Deductibility of Corporate Salaries*

1. *President's Proposal.* The President's proposal would preclude a corporation from taking a deduction for compensation paid to an executive in excess of $1 million per year. The $1 million limitation would not apply to compensation payments that are linked to productivity, though no details of the productivity exception have yet been released.

2. *TEI Position.* TEI opposes the proposal to arbitrarily limit the deduction for corporate salaries for a number of reasons. First, the proposal to limit the deductibility of corporate salaries violates the basic tenet of America's net income tax system that taxpayers are allowed to deduct their ordinary and necessary business expenses.[1] Enacting a proposal to limit the compensation deduction would give rise to the double taxation of salaries — once at the individual level (as is currently the case), and once at the corporate level (as a result of the denial of a deduction). This alone should be sufficient reason to defeat such a proposal.

In addition, a corporate compensation limitation would discriminate against similarly situated individuals — for example, corporate executives and non-corporate executives whose duties are virtually identical — without any public policy basis. Hence, limitations would not apply to employees of a partnership who perform services substantially identical to those performed by corporate executives at a competing firm, nor would they apply to non-executive employees or to employee-owners of personal service corporations. An enterprise or group of individuals choosing to conduct business as a corporation would find itself subject to the limitation, whereas the same business would escape the limitation's reach by organizing itself as a partnership; investment banking is but one example where firms performing substantially identical services are organized as either partnerships or corporations. In addition, the proposal would not reach certain industries (*e.g.*, law and accounting firms) that generally operate in non-corporate form.[2] Contrary to the avowed purpose of the Tax Reform Act of 1986 (and other recent legislation), therefore, a corporate salary

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[1] The Internal Revenue Service currently has ample authority to challenge the reasonableness and, hence, the deductibility of excessive salaries. Indeed, the case law is replete with examples of situations where the IRS has *successfully* argued that no deduction should be allowed for an unreasonably large salary on the grounds that the payment constitutes a disguised dividend. In other words, the President's proposal is not necessary to protect against tax law abuses.

[2] Under the proposal, the limitation would apply to the salary paid to a corporate general counsel but not to the fees paid by the corporation to its outside counsel, frequently for substantially similar services.

deduction limitation would violate the principle of neutrality and interfere with basic business decisions.

Although the details of the President's proposal remain unclear (especially with respect to any exception for payments linked to productivity), significant issues of retroactivity exist in respect of stock options and forms of deferred compensation "granted" before, but not taxable to the employee (or deductible to the employer) until after, the effective date. Thus, the putative rationale of policing "excessive" corporate compensation is undercut because a limitation on deductibility could obviously not discourage already-granted compensation. Equally important, a limitation proposal would penalize taxpayers who granted stock options as a form of compensation over the same period of time they may have paid their employees lower cash wages. At a minimum, the limitation should not apply to compensation paid pursuant to agreements entered into before the date the Committee adopts the proposal, without regard to whether such amounts are vested or funded at the date of committee action.

Moreover, through its application to compensation in the form of stock options, the President's proposal runs counter to national policies of encouraging entrepreneurship. As SEC Chairman Breeden testified last summer, converting employees into owners (through the grant of stock options) is highly desirable and should be facilitated, not impeded. The President's proposal would discourage businesses from developing compensation arrangements pursuant to which employees would accept lower current wages in exchange for the opportunity to share in the future profits of the corporation as a shareholder. Although the announced (but inchoate) productivity exception might ameliorate the effect on stock option grants, query whether a productivity-based exception would in practice become nothing more than a mirror image of the limitation that exists under current law, *viz*, compensation is deductible only to the extent it is ordinary and necessary. The productivity standard would necessarily involve either the application of bright-line tests to determine the "productivity" of the employee or an examination of all the facts and circumstances in a particular case. The application of any objective standard established by legislative fiat would prove extremely rigid with arbitrary and inconsistent results among different businesses or even to different classes of employees within the same company.[3] Should a facts-and-circumstances test be mandated, the President's proposal would add nothing but gloss to the existing standard. That "gloss," however, could lead to unproductive disputes between taxpayers and the IRS. In any event, the IRS would likely be flooded with ruling requests on whether particular arrangements satisfied the productivity exception.

Finally, a corporate salary deduction limitation represents a crude attempt to deal with an issue of corporate governance through the tax code. Such a limitation would subject all corporations — no matter how large or small, no matter how successful, no matter how important the executive is to the company's success — to the same arbitrary rule.[4] It would thus ignore the specific facts and circumstances that could make compensation in excess of an enacted limitation clearly proper — in the words of the Internal Revenue Code, "ordinary and necessary." To the extent so-called excessive corporate compensation is a matter of national concern, TEI believes the issue should be dealt with as a matter of corporate governance — for example, through further revision of certain SEC rules relating to shareholder oversight of executive salaries[5] — not the tax law.

For the foregoing reasons, TEI recommends that the proposed limitation on the deduction of executive compensation be rejected.

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[3] While there are elements of compensation packages that are common to all or many employers, there is a whole industry of compensation consultants and corporate human resources employees who devote their full-time energies to devising incentive compensation arrangements that meet the particular, unique needs of individual enterprises. We doubt that an entirely objective, bright-line tests of productivity will be flexible enough to accommodate all employees or all types of businesses.

[4] That it is not possible to establish a reasonable, generally applicable cap on deductible compensation is underscored by reference to the sporting and entertainment worlds. Many people might question whether certain professional athletes or entertainers are "worth" the salaries they command, but the fact is, their value is set in the marketplace. In the same fashion, corporate shareholders, acting by and through corporate boards of directors, determine the *value* of services provided by corporate executives. An arbitrary limitation on deductions for corporate salaries will likely not reduce the salaries paid to executives, because the value of their services will be set by a competitive market. Instead, the cost of increased corporate taxes caused by the disallowed deductions will be borne by either the customers or the shareholders of the corporation.

[5] We recognize that the SEC recently revised its rules relating to the disclosure of executive compensation in proxy materials and submit that such rules — not the tax code — are the proper venue for addressing issues of "excessive" executive compensation.

B. Lobbying Expenses

1. *President's Proposal.* Under current law, businesses may deduct the cost of certain lobbying expenses as ordinary and necessary business expenses. Under section 162(e) of the Code, deductible expenses include amounts paid or incurred for direct communications with Congress or another legislative body; the cost of communicating with a trade organization of which the taxpayer is a member in regard to relevant legislation; and a part of the dues for membership in an organization that engages in lobbying. Under the President's proposal, businesses would no longer be able to deduct lobbying expenses. Lobbying expenses would be defined similarly to the definition of expenditures to influence legislation in section 4911(d) and would include attempts to influence legislation through communications with the executive and legislative branches. In addition, no part of membership dues that are used for such lobbying would be allowed as a deduction and the membership organization would be required to report to members the portion of the dues used for lobbying.

2. *TEI Position.* Section 162(e) was enacted in 1962 to permit deductions for direct lobbying expenses. The legislative history to that provision shows that Congress overturned previous judicial precedent and administrative practice (i) to remedy the inconsistent treatment of expenses incurred in petitioning for judicial and legislative redress of grievances; (ii) to eliminate the disincentive of seeking legislative contact, providing factual knowledge to the legislature, or lending the taxpayers expertise to legislative deliberations; (iii) to provide a better reflection of the taxpayer's true net income; and (iv) to eliminate the compliance and enforcement problems associated with identifying and segregating proscribed expenditures.

"Lobbying" is not a four-letter word. Efforts to punish taxpayers for asserting their First Amendment right to petition for redress of grievances should not be allowed to masquerade as political reforms or attacks on "special interests." The pervasive influence of federal laws and regulations on the conduct of business in America ensures that companies, industries, and the general populace will continue to have an interest in communicating their views to Congress and the Administration. In other words, lobbying will continue. Indeed, Congress and the federal regulatory agencies can hardly expect to develop legislation and to promulgate rules and regulations without accumulating a certain degree of information about the subject matter and practices they seek to regulate. Without the active participation of trade or professional groups and individual businesses in the legislative and regulatory process, rules are likely to be fashioned in a void, spawning economic inefficiencies and imposing compliance burdens that are wholly avoidable. The tax law itself is replete with examples of Congress enacting requirements with too little — not too much — information. (Witness the ill-fated section 89 or — more recently — the luxury excise tax.) Indeed, Congress recognized its need for information from affected constituencies when it enacted section 162(e):

> It also is desirable that taxpayers who have information bearing on the impact of present laws, or proposed legislation, on their trades or businesses not be discouraged in making this information available to the Members of Congress or legislators at other levels of government. The presentation of such information to the legislators is necessary to a proper evaluation on their part of the impact of present or proposed legislation. The deduction of such expenditures on the part of business is also necessary to arrive at a true reflection of their real income for tax purposes. In many cases making sure that legislators are aware of the effect of proposed legislation may be ***essential to the very existence of the business.*** (Emphasis added.)[6]

Not only is it important that information be made available to Congress and other legislative bodies, the administrative burden associated with identifying and segregating "lobbying expenses" from other expenditures could prove exceedingly difficult for taxpayers to comply with and the IRS to audit. Controversy would inevitably arise over the types of expenditures included within the definition of lobbying. In enacting section 162(e), Congress wisely sought to quell such controversies. The legislative history confirms the wisdom of permitting a deduction for lobbying expenses as ordinary and necessary business expenses as a matter of administrative convenience:

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[6] *See* H.R. Rep. No. 1447 (Report of the Committee on Ways and Means to accompany H.R. 10650), 87th Cong., 2d Sess. 16 (1962), *reprinted in Legislative History of H.R. 10650 (The Revenue Act of 1962)*, Public Law No. 87-834, Part 1, at 1151 (1967).

> The regulations issued by the Treasury Department in 1959 brought to a head many administrative and enforcement problems and uncertainties which have plagued both the Government and taxpayers. The difficulty in allowing trade or business expenses generally, but isolating expenses relating to legislative matters and denying deductions for them, stems in part from the difficulty in segregating and classifying such expenses. . . . Moreover, in the case of many expenses which may primarily be incurred to inform the business itself as to the application of certain proposed legislation, when such information is also made available to legislators it is difficult to determine how an allocation of the expense should be made between legislation and mere planning of the company.[7]

Depending on the complexity of the prescribed allocation scheme, industry associations, trade groups, or research organizations whose legislative activities are minor (perhaps even *de minimis*) compared with their educational, research, or other activities might choose to curtail or terminate their lobbying rather than incur the expenses associated with segregating lobbying from their other activities and then notifying their members of the portion of their dues ensnared in the disallowance. (Small and medium-sized businesses might also refrain from lobbying, not because of the "cost" of nondeductibility but because of the attendant recordkeeping burdens.) The "losers" in the process could well be Congress, the Administration, or the country as a whole — they would be deprived of the knowledge those "lobbyists" would otherwise bring to the legislative process. And, we submit, the fisc would not be at all enriched.

Of the four reasons cited by Congress in 1962, the erosion of the principle that the income tax is derived after measuring the *net income* of the taxpayer is the most important for opposing enactment of the provision. We believe that the compromise struck by Congress in enacting section 162(e) strikes an appropriate balance between direct lobbying and "grass roots" lobbying activities. Should Congress determine that some action is necessary to address the "power" of the "special interests," then TEI submits that non-tax laws — such as those governing campaign finances and the disclosure of lobbying activities and expenditures — should be the vehicle for reform.

TEI urges that the proposed disallowance of deductions for lobbying expenses be rejected.

C. *Deductible Portion of Business Meals*

1. *President's Proposal.* Under section 274(n) of the Code, a taxpayer is permitted to deduct only 80 percent of the expense for meals and entertainment that meet certain legal and substantiation requirements to establish the business purpose of the expense. The President's proposal would reduce the deductible portion of the otherwise allowable business meals and entertainment expenses from 80 percent to 50 percent.

2. *TEI Position.* The justification proffered by the Administration for the proposed reduction in the percentage of the allowable deduction is that a portion of the expense relates to an entirely personal and, hence, nondeductible expenditure. Allowing a full (or even 80-percent) deduction for consumption of the business meal, the summary of the President's proposal states, amounts to an improper tax subsidy for a personal expense of the employee.

Apart from a possible search for revenues, we are unable to discern how the Administration arrived at the proposed 50 percent disallowance figure. How was the personal element of the business meal expenditure determined to be one half of the expenditure? We respectfully suggest the determination was arbitrary and devoid of any legitimate tax policy rationale. Indeed, the President's proposal ignores the underpinnings of current law in disallowing deductions for ordinary and necessary business expenses incurred primarily to produce taxable income. The proposal is based on the notion that any *incidental* personal benefit that accrues from an expenditure may be measured and should be eliminated from the tax base. The quest for such a theoretically perfect measure of the tax base, however, is not only flawed but wasteful of taxpayer and government

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[7] *Id.*

resources because it violates the economic law of diminishing returns.[8] In 1986, TEI opposed the proposed 20-percent disallowance on the ground that it represented bad tax policy and would impose administrative burdens likely to exceed the incremental revenues raised by the provision. We believe those arguments apply with equal force to the proposed racheting up of the disallowance to 50 percent.

Accordingly, TEI urges that the provision to disallow a deduction for 50 percent of the cost of meals and entertainment be rejected. Indeed, for the foregoing policy reasons, TEI believes the current 20-percent disallowance should be repealed.

D. Club Dues

1. *President's Proposal.* Under section 274(a) of the Code, a deduction is permitted for club dues if the taxpayer establishes that the use of the club is *primarily* for furtherance of the taxpayer's trade or business. Even after this test is met, the taxpayer is permitted to deduct only that portion of the dues that qualify as "*directly related*" to the active conduct of the trade or business. The President's proposal would disallow entirely deductions for expenditures for all manner of club dues including business, social, athletic, luncheon, and sporting clubs.

2. *TEI Position.* As with the deduction for business meals, the putative reason for the proposed change is that taxpayers obtain a deduction for dues for a club (such as a country club) with respect to which a significant element of personal pleasure, enjoyment, and social benefit is present. This facile explanation should be rejected in light of the formidable gauntlet of tests already imposed by the Code to establish that an expenditure for club dues is *directly related* to the active conduct of a taxpayer's trade or business. If a taxpayer is able to surmount the obstacles in present law and establish that the expenditure is directly related to the conduct of its business, a net income tax system demands that ordinary and necessary expenses related to the production of the income be deductible.[9]

TEI urges that the elimination of the deduction for club dues be rejected.

Corporate Estimated Taxes

1. *President's Proposal.* Under section 6655 of the Code, a corporation is subject to an addition to tax (or penalty) for any underpayment of estimated tax. For taxable years beginning after June 30, 1992, and before 1997, a corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 97 percent of the tax liability shown on its return for the current taxable year. For taxable years beginning after 1996, current law provides that the 97-percent requirement will be reduced to 91 percent. The President's proposal would make the 97-percent requirement permanent.

2. *TEI Position.* Current law effectively requires large corporations to overpay their estimated taxes, without the benefit of interest, in order to avoid an underpayment penalty under section 6655 of the Code. This Hobson's choice — between a penalty and what is essentially a non-penalty penalty — does not confront other taxpayers because they may generally avoid the section 6655 penalty by availing themselves of the statutory safe harbor. Specifically, smaller corporations — those whose taxable income is less than $1 million for all of the preceding three years — may avail themselves of a statutory safe harbor to avoid the underpayment penalty by making quarterly deposits equal to 100 percent of their prior year's tax liability. Because the safe harbor is based on the company's prior year's liability (which obviously is known), smaller companies can approach the estimated tax rules with confidence. Large corporations currently may not use this prior year's safe harbor.

Because they are not permitted to use the prior year's tax rule, large corporations must base their quarterly deposits on estimates of their current year's tax liability. The existing task is literally

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[8] At best, the President's proposal is a blunt instrument: the disallowance would apply equally to both the sandwiches consumed during an all-day business meeting and the proverbial "three-martini lunch."

[9] While references to "country clubs" conjure up pictures of abuse, TEI questions why no exception is provided for facilities having absolutely no mixed business and personal uses, *e.g.*, a business lunch club (with no accompanying athletic facility privileges) that is open only during business hours.

impossible in light of the complexity of the tax laws, the rapidity with which they have changed in recent years, and the fact that numerous adjustments to financial income can accurately be done only annually. Consequently, the large corporate taxpayer faces a choice of either (i) paying a penalty (under section 6655) for underestimating its liability or (ii) overpaying its taxes (in order to avoid the penalty).

The second option (which large corporations are generally compelled to choose not only by internal business conduct policies but by business exigencies — the desire to avoid penalties) does not come without a cost. The cost is the effective denial of interest on the mandatory overpayment by operation of section 6611(e), which provides that interest on an overpayment does not begin to run until the filing of a claim for refund. The President's proposal would exacerbate a serious administrative difficulty that exists under current law.

TEI recommends that the estimated tax proposal in the President's package be rejected and the corporate estimated tax provisions of the Code be truly reformed. Although we question whether a valid tax policy reason exists for denying "large corporations" the availability of the prior year's tax rule under section 6655, we suggest that either of the following alternatives would temper the unfairness and unrealistic nature of the current rules:

- *Alternative One:* No penalty would be imposed if the taxpayer makes estimated tax payments based on a specified percentage (say, 120 percent[10]) of the average of its tax liabilities for the preceding three (or more) years (after taking into account credits).

- *Alternative Two:* In the event the taxpayer overpays its estimated taxes, interest (at the rate prescribed by section 6621(a)(1) of the Code) would be paid to the taxpayer on the amount of the overpayment from (i) the later of the due date of the estimated taxes or the date payment is made, to (ii) the date such overpayment is refunded (or applied to a subsequent liability).

Modification of the AMT Depreciation Schedule

1. *President's Proposal*. Under current law, taxpayers are subject to an alternative minimum tax (AMT) and must make adjustments to their regular taxable income to arrive at their AMT income. One of these adjustments relates to depreciation. Under the AMT, depreciation for personal property placed in service after 1986 is generally computed under the modified accelerated cost recovery system (MACRS) using the 150-percent declining balance method (switching to straight line at a point maximizing the deduction). The class lives for AMT depreciation purposes are generally longer than those permitted for regular tax purposes. For taxable years beginning after 1989, corporate AMT income is increased by an amount equal to 75 percent of the amount by which the adjusted current earnings (ACE) of the corporation exceed AMT income. In general, ACE requires additional adjustments to AMT income. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property.

For property placed in service after December 31, 1993, the President's proposal would eliminate the depreciation component of the adjustment used in computing ACE; depreciation for purposes of the AMT would be computed using the 120-percent declining balance method over the recovery periods applicable for regular tax purposes. The amendment would not apply to property eligible only for the straight-line method for regular tax purposes (*i.e.*, residential and nonresidential property).

2. *TEI Position*. In our view, the AMT provisions of the Code stand as an admission of the tax law's failure. The AMT takes away with one hand the tax treatment given by the other hand, and in the process, it unduly burdens taxpayers. For example, the AMT regime requires taxpayers to make three separate computations to determine regular taxable income and AMT income. Our preference — from both a tax administration and tax policy perspective — would be to repeal the AMT. Recognizing that such a change is unlikely to occur, however, we welcome the Administration's modest step toward simplification of the system.

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[10] This percentage could be adjusted to ensure that the rules are not manipulated to the government's detriment.

The AMT treatment of depreciation is clearly a source of considerable complexity in the Code. Rather than recognizing that the mere existence of two separate and distinct federal taxing schemes breeds inordinate complexity, however, the President's proposal sets forth a partial solution that would apply only in calculating the AMT/ACE rules for *newly acquired property*. It regretfully ignores the requirement that taxpayers comply with the ACE requirements beginning in 1990 and the fact that, even under the proposal, they would continue to "track" the various depreciation regimes for assets acquired before the effective date of the simpler method (with some assets having depreciable lives of 40 years or longer). Indeed, for some taxpayers the provision may actually increase their burden by forcing them to maintain one more depreciation system for property placed in service before 1994. We urge the Committee to address this problem.

TEI applauds the concept of computing AMT depreciation only once and recommends that taxpayers be accorded an election to apply the simplified method retroactively for all years to which ACE applies.

Permanent Extension of Employer-Provided Educational Assistance, Targeted Jobs Tax Credit, and the Research Tax Credit

1. *President's Proposal*. Section 127 of the Code excludes from taxation the value of certain employer-provided educational assistance. Since its enactment in 1978, section 127's exclusion has expired and been extended six times (five times retroactively). The provision expired on June 30, 1992. The President's proposal would make the exclusion permanent, retroactive to July 1, 1992.

The President's proposal would also permanently extend the targeted jobs credit under section 51 of the Code. This statute has been extended four times since its enactment in 1976 and expired on June 30, 1992. The President's proposal would retroactively reinstate the credit for individuals who begin work for the employer after that date.

Finally, the Administration proposes to permanently extend the research tax credit under section 41 of the Code. This provision was originally enacted in 1981 and has been extended five times; it expired on June 30, 1992. Under the proposal, the credit would apply to expenditures incurred on or after June 30, 1992.

2. *TEI Position*. TEI believes the President's proposal to make these three incentives permanent represents a very positive step. Permanence would enhance the incentive effect of the educational assistance, targeted jobs, and research tax credit provisions of the Code and, taken together, would further the goal of tax system stability. Indeed, we believe that the uncertainty and confusion caused by the repeated "sunsetting" of the provisions since their original enactment greatly diminished their incentive effect. The on-again, off-again nature of the provisions also imposed substantial administrative burdens on taxpayers. For example, with respect to employer-provided educational assistance, employers have been required to design and implement programs to tax and withhold the value of such assistance, only to modify (or undo completely) those programs on an after-the-fact basis.

Employees, too, have been subject to confusion and hardship from the see-sawing effect of extensions and retroactive legislation. Employer educational assistance and the targeted jobs credit provide job opportunities and advancement for lower-paid and unskilled workers. By making sections 127 and 51 permanent, the administrative confusion for employers and the financial burden for employees could be ameliorated.

With respect to the research tax credit, corporations generally plan for research and development projects years in advance. The repeated, short-term reenactment of the tax credit cannot help but engender uncertainty and impede the incentive effect of the R&D provision. A permanent extension would reduce complexity and permit taxpayers to effectively plan their research activities, thereby furthering the legislative intent underlying the credit.

TEI therefore supports the permanent extension of the educational-assistance exclusion, the targeted jobs credit, and the research tax credit.

Allocation of Research and Experimentation Expenses

1. *President's Proposal*. Treas. Reg. § 1.861-8(e)(3) generally provides that research and experimentation (R&E) expenses may be allocated to domestic and foreign source income based on either the taxpayer's relative amounts of domestic and foreign source gross income or the taxpayer's relative gross sales receipts from domestic or foreign sources. If the sales method is used, the taxpayer must first allocate 30 percent of its R&E expense to gross income from the location where most of its R&E activity is conducted. Since 1981, the regulation has been modified eight times by temporary legislation. The most recent statutory rule permits the taxpayer to allocate 64-percent of U.S.-based R&E expense to domestic source income and 64-percent of foreign-based R&E expense to foreign source income. The statutory rule expired on June 30, 1992, but a Treasury announcement permits the taxpayer to continue using the 64-percent allocation rule until the end of 1993.

The President's proposal would allocate 100 percent of the R&E expense to the place of performance of the R&E. The proposal would apply to taxable years beginning after December 31, 1993.

2. *TEI Position*. TEI agrees that a permanent solution to the allocation of R&E expense is warranted. The on-again, off-again effect of the frequent statutory modifications has been counterproductive to fostering U.S.-based research. As the summary of the President's proposal states, "A direct allocation of United States-based R&E expenses to domestic source income encourages taxpayers to conduct R&E in the United States." The allocation rules under the Treasury regulations represent a clear disincentive to the performance of R&E activities in the United States. It is time for Congress to simplify the R&E allocation rules and make them permanent. Simplicity and permanence would reduce the compliance costs associated with the complex, changing rules. We believe that the President's proposal would accomplish these goals.

TEI therefore recommends adoption of the rule to allocate R&E expenses to the place of performance.

Treatment of Royalties as Passive Income for Foreign Tax Credit Purposes

1. *President's Proposal*. To ensure that the foreign tax credit offsets only the U.S. tax on the taxpayer's foreign source income, section 904 of the Code prescribes a statutory limitation formula. This foreign tax credit (FTC) limitation is calculated separately for certain categories — or "baskets" — of income, including passive income. Passive income generally includes rents, royalties, interest, and other types of income defined in section 954(c) of the Code (generally referred to as "foreign personal holding company income"). There are two exceptions for royalty income: (i) certain royalties received from foreign affiliates are categorized on a "look-through" basis that often results in the royalties being treated as general limitation income; and (ii) royalties received from an unrelated party in the active conduct of a trade or business are excluded from the passive basket.

The President's proposal would provide for the treatment of all foreign source royalty income as income in the separate basket for passive income. The summary of the President's proposal states that the provision is necessary to remove the preference for foreign licensing of intangibles. The summary also states that "[p]lacement of royalties in the passive category would generally eliminate existing opportunities for cross-crediting of high foreign taxes paid on other business income against low-taxed royalty income." The provision would apply to taxable years beginning after December 31, 1993.

2. *TEI Position*. In 1986, Congress greatly expanded the categories of income that must be segregated into FTC "baskets." To prevent taxpayers from avoiding these limitations, it also expanded the types of income subject to section 904(d)(3), which prescribes "look-through" rules to preserve the character of income when it is earned through related parties.[11] In enacting the 1986 amendments, Congress concluded that the overall limitation was consistent with the integrated nature of U.S. multinational operations and that the averaging of foreign tax rates generally should be allowed. It recognized, however, that cross-crediting should not be allowed when it would distort

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[11] From 1984 (when section 904(d)(3) was enacted) to 1986, a limited "look-through" rule applied to dividends, Subpart F income, and interest.

the purpose of the FTC limitation.[12] It provided a separate FTC basket for passive income because of its concern that passive investments can often be quickly shifted or easily made in low or no tax jurisdictions.[13]

TEI submits that allocating royalties from a related party to the passive basket would undermine the policy decisions made when the 1986 Act was enacted. Moreover, the proposal would actually serve as a disincentive to companies to repatriate their earnings and would exacerbate double taxation by creating excess FTCs that may never be offset against U.S. income.

The look-through rules embodied in section 904(d)(3) recognize that royalties received from a related party should retain the character of income out of which the royalty was paid. Interest, rents, and royalties received from a related party are all payments of the earnings of a foreign affiliate. Realization that the "form" of the repatriation should not lead to a different characterization under the FTC rules led the American Law Institute to conclude in 1986 that royalties passing from one member of an affiliated group to another have the same character and should be treated as non-passive income, unless the underlying income of the related party is passive. In such circumstances, the royalty is just one part of an integrated enterprise.[14]

In enacting the expanded look-through rules in 1986, Congress also recognized that interest, rents, and royalties often serve as alternatives to dividends as a means of removing earnings from a foreign affiliate. Congress determined that such income should be treated at least as favorably as dividends eligible for the deemed paid credit so that payment of the former would not be discouraged, stating that because interest, rents, and royalty payments are generally deductible in foreign countries (while dividends are not), they "reduce foreign taxes of U.S.-owned foreign corporations more than dividend payments do."[15]

The Administration argues that treating all foreign source royalty income as passive would eliminate the tax preference for licensing intangibles to a foreign person for use in production activities abroad. This argument, however, ignores the manner in which companies conduct business. For economic, non-tax business reasons, many businesses must produce their products close to the place of sale. A manufacturer of processed foods, for example, will license his patent on the products to an overseas subsidiary to preserve freshness, to adapt to local market conditions, or to avoid the high cost of shipping those products for sale into that region. Forcing such a company to make an uneconomic — and uncompetitive — decision to avoid the receipt of passive basket income would be counterproductive. Moreover, treating all royalty income as passive might cause companies to locate their R&D activities abroad, thereby frustrating the policy underlying the President's proposal concerning the allocation of R&D expenditures.

The Administration also argues that the provision is necessary to prevent the cross-crediting of high-taxed income with low-taxed royalties. Again, this argument ignores the fact that multinational corporations generally conduct their business on a worldwide basis. In 1977, a task force chaired by Congressman Rostenkowski concluded that the averaging of foreign taxes was frequently appropriate, explaining —

> Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region

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[12] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 862 (1987) (hereinafter cited as the "*1986 General Explanation*").

[13] *Id.* at 863.

[14] American Law Institute, *International Aspects of United States Income Taxation* 247 (May 14, 1986) (hereinafter cited as the "*ALI Report*").

[15] H.R. No. 99-426, 99th Cong., 1st Sess. 341 (1985) (hereinafter cited as the "*House Report*"). *See also 1986 General Explanation* at 866. Moreover, Congress concluded that the look-through rule for royalties reduces the disparity between the tax treatment of branches and subsidiaries:

> Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (as through a foreign branch) and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation.

1986 General Explanation at 866.

> (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.[16]

Although Congress has rejected the enactment of one overall FTC limitation, it has generally restricted the separate FTC limitations to classes of income that were "movable."[17] Because the source of royalty income depends upon the country in which the use of (or right to use) the intangible arises, the source is not "movable" in the same sense that other income may be.[18]

In the 1986 Act, Congress actively sought to *encourage* the payment of royalties because it believed that such payments acted to preserve the U.S. tax base. As the House Ways and Means Committee determined —

> Under the foreign tax credit system, the payment of interest and royalties by controlled foreign corporations and other related foreign corporations whose dividends carry a deemed-paid credit may, therefore, reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends.[19]

Congress should not now unravel that determination by treating all royalties as passive income.[20]

TEI therefore recommends that royalties should not be treated as passive income for purposes of the foreign tax credit limitation.

Current Taxation of Certain Earnings of Controlled Foreign Corporations

1. *President's Proposal.* The United States generally does not tax the foreign income of foreign subsidiaries of U.S. corporations when earned. Rather, the tax on foreign income is "deferred" until the income is repatriated through the payment of dividends to the parent corporation. There are, however, several exceptions to the deferral rule. Under Subpart F of the Code, certain types of income received by controlled foreign corporations (CFCs) are currently taxed as a constructive dividend to U.S. shareholders. Subpart F income is generally income that is considered "movable" from one taxing jurisdiction to another and that is subject to low rates of tax.

The passive foreign investment company (PFIC) rules overlap with the Subpart F rules to tax active overseas business operations. The PFIC rules were enacted in 1986 to remove the economic benefit of tax deferral and the ability to convert ordinary income into capital gain which was available to U.S. investors in foreign investment funds. Unfortunately, the definition of a PFIC is so broad it has resulted in the classification of many corporations with active businesses (and substantial passive income or assets) as PFICs — even in situations where the foreign corporation is subject to high rates of tax.

The President's proposal would require 10-percent U.S. shareholders of certain CFCs to include in income currently their pro rata shares of a specified portion of the CFC's current and

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[16] House Committee on Ways and Means, *Recommendations of the Task Force on Foreign Source Income*, 95th Cong., 1st Sess. 35 (March 1977).

[17] *See House Report* at 333.

[18] *ALI Report* at 342.

[19] *House Report* at 341.

[20] With respect to royalties from unrelated parties, the ALI Report concludes that for self-developed intangibles, licensing "can be said to be merely one of the many techniques for realizing a return on the resulting asset and should not be differentiated from the use of the property by, for example, a foreign subsidiary that utilizes the property in carrying on its own business." *ALI Report* at 342. Again, because the source of the royalty is not "movable," the ALI Report concludes that the royalties should be left in the general limitation basket. *Id.* We submit that royalties received in the active conduct of a trade or business should not be relegated to the passive limitation basket.

accumulated earnings. The proposal would apply to a CFC — including a CFC that is a PFIC — holding passive assets that represent 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includible earnings") would be the lesser of (i) total current and accumulated earnings and profits, or (ii) the amount by which the value of the CFC's passive assets exceed 25 percent of the value of its total assets. The proposal would generally be effective for taxable years beginning after December 31, 1993. The proposal would provide for a phase-in of the amount subject to current inclusion over a five-year period.

2. *TEI Position*. TEI strongly objects to the proposal to tax in advance of repatriation to the United States certain accumulations of foreign earnings deemed to be "excessive." As a policy matter, the Institute disputes the need to overlay another type of regime on top of Subpart F. The PFIC provisions — which themselves are a prime example of legislative overkill — were enacted to prevent the very situation that the Administration now seeks to address: to eliminate deferral on passive assets. We submit that the last thing the tax system needs is another regime that, in terms of tax policy, is wholly redundant. In terms of administration, the President's proposal is tremendously complicated. It would add needless complexity to an already complex area and reduce the ability of U.S. multinationals to compete abroad. Moreover, we question whether the proposal would encourage companies tc invest in facilities in the United States since corporations investing overseas generally tend to "plow back" the resulting profits in the business of that foreign affiliate. In reality, the provision could perversely act as an inducement to invest in active manufacturing facilities abroad to reduce a company's passive assets.

Finally, TEI objects to the provision to the extent that it would tax retained earnings and assets of foreign subsidiaries from prior years. Such retroactive application of the tax laws would be unwarranted and — quite frankly — inequitable. The retroactive effective date would also be unprecedented; when similar provisions (such as section 956's investment-in-U.S.-property regime) were enacted, the statute applied prospectively to future investments.

TEI therefore opposes the repeal of deferral for "excessive" earnings of controlled foreign corporations.

Transfer Pricing Initiative

1. *President's Proposal*. Section 6662 of the Code imposes a penalty of 20 percent of the amount of any understatement of tax attributable to "substantial valuation misstatements." Under section 6662(e), the penalty is imposed either (i) when the transfer price adjustments in any one taxable year exceed $10 million, or (ii) when the transfer price or adjusted basis for property or services exceeds 200 percent or more (or is 50 percent or less) of the amount ultimately determined to be the "correct" transfer price. This so-called section 482 penalty is increased to 40 percent of the understatement if there is a "gross valuation misstatement," which is defined as adjustments exceeding $20 million, or 400 percent or more (or 25 percent or less) of the "correct" transfer price. Under section 6664(c), the penalty does not apply to any portion of the understatement if the taxpayer has reasonable cause for the position taken and acted in good faith with respect to that position.

The President's proposal would amend section 6662(e) to provide that the reasonable cause and good faith exception will be satisfied only if the taxpayer provides contemporaneous documentation demonstrating the application of one or more reasonable transfer pricing methodologies to the taxpayer's controlled transactions. In order for the application of the transfer pricing methodologies to be reasonable, any procedural or other requirements imposed by regulation must be observed and documented. In addition, methods other than those specifically prescribed in the regulations may be reasonable if the taxpayer establishes that, at the time of the transaction, the prescribed methods will not be likely to lead to an arm's-length result and that the so-called fourth method actually applied was likely to lead to such a result. The provision would be effective for taxable years beginning after December 31, 1993.

2. *TEI Position*. The President's proposal essentially codifies the reasonable cause and good faith exception set forth in the recently proposed section 6662 regulations (which require contemporaneous documentation to escape the section 482 penalty). Although the Institute generally supports the codification of a specific reasonable cause exception, we believe significant questions remain about the proposed standard, especially to the extent it becomes the exclusive means of escaping the section 482 penalty.

Penalties are generally intended to encourage compliant behavior and to punish taxpayer misconduct. (Their purpose should never be to raise revenue.) To be effective in deterring culpable behavior, the penalty must warn taxpayers *in advance* that they will be held to a certain standard of conduct. We submit that in areas where reasonable parties may differ, the mechanical assertion of penalties is simply wrong.

The determination of the "correct" transfer price between related parties is an inherently factual, complex undertaking. Recent court cases demonstrate that highly trained economic experts may substantially disagree on the proper pricing method in a particular factual setting. The recently proposed section 482 regulations themselves acknowledge that there is rarely any single, unassailable "right" answer.[21] In these circumstances, the section 482 penalty should not be routinely applied; rather, it should be limited to instances of truly culpable behavior.

TEI submits that the reasonable cause exception should encompass safe harbors or presumptions of good-faith conduct. We recommend that the contemporaneous documentation requirement in the President's proposal be recast as a safe harbor from assertion of the penalty. In other words, a taxpayer should be entitled to a presumption of reasonable cause and good faith where it can show that it has adopted a business policy designed to establish arm's-length prices between related parties, produces contemporaneous documentation showing how the transfer price was set, and verifies that the business policy was in fact followed. Such a provision would serve two purposes: (i) it would mitigate the severe underpayment penalty that may result from second-guessing a taxpayer's analysis and interpretation of complex factual data; and (ii) it would clarify the definition of "contemporaneous documentation" (which is undefined in both the President's proposals and the section 482 penalty regulations).[22]

Having contemporaneous documentation of transfer prices, however, cannot and should not be the sole means of satisfying the reasonable cause exception. Other safe harbors should be available. For example, if a taxpayer's pricing methodology has been continuously reviewed by the IRS for a certain number of years and found acceptable, reasonable cause and good faith should be deemed to exist. The reasonable cause and good faith standard should also be deemed satisfied for the amount of any timely, voluntary, self-assessed adjustment. Thus, where a taxpayer voluntarily self-assesses a net section 482 adjustment by filing an amended return, brings the adjustment to the attention of an IRS agent during an audit, or otherwise corrects an error through its normal accounting procedures, no penalty should be assessed. TEI believes that self-assessment upon the discovery of an error is evidence of good faith compliance that should negate any otherwise applicable section 482 penalty.[23]

TEI also believes that taxpayers who wish to use the so-called fourth method for establishing transfer prices should not be required to prove the inapplicability of the other prescribed methods in order to avoid the section 482 penalty. Establishing the inapplicability of a pricing method effectively requires the taxpayer to prove a negative — that no other pricing methodology produces an arm's-length price — and creates the presumption that the use of an "other" method is inherently wrong. This is a difficult — if not impossible — burden to meet.

In sum, TEI recommends that the President's proposal be revised to codify a "contemporaneous documentation" standard as a safe harbor — i.e., as one means of satisfying the reasonable cause and good faith exception of section 6662(e). In addition, the proposal should be revised to eliminate the requirement that a taxpayer disprove the applicability of the other prescribed methods to establish reasonable cause.

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[21] *See* Prop. Reg. § 1.482-1T(d)(2) (permitting a range of arm's-length prices to be used under all methodologies).

[22] The lack of a definition for "contemporaneous documentation" causes considerable administrative problems. What, for example, will be considered "contemporaneous"? Must taxpayers have the documents "in hand" in order to rely upon them? Will it be sufficient for the foreign affiliate to certify that the documents exist? What is the effect of documents that come into existence after the return is filed, but support the use of the methodology? Will they be ignored? The term clearly needs to be clarified, especially if it becomes the sole means of avoiding the section 482 penalty.

[23] TEI continues to believe that sound policy requires the enactment of a *de minimis* rule, based on a percentage of total intercompany sales. Thus, where the total net section 482 adjustments are insubstantial (say, 10 percent) in relation to the value of the taxpayer's total gross intercompany transactions subject to scrutiny under section 482, a penalty should not be asserted. We submit that such a rule is necessary in light of the size and multitude of intercompany transactions that must be monitored by large corporations.

Earnings Stripping Rules

1. *President's Proposal*. Section 163(j) was added to the Code in 1989 to prevent the possible erosion of the U.S. tax base by the use of excessive deductions for interest paid by a taxable corporation to a tax-exempt related party. In enacting the earnings stripping provision, Congress was primarily concerned with the thin capitalization of corporations. The current provision limits the U.S. interest deduction when (i) a corporation's debt-to-equity ratio exceeds 1.5 to 1; (ii) the interest is paid to a related party who is exempt from U.S. taxation; and (iii) the corporation has "excess interest expense," *i.e.*, its net interest expense exceeds 50 percent of its adjusted taxable income plus the excess limitation carryforward.

The President's proposal would provide that any loan from an unrelated lender that is guaranteed by a related party would be treated as related party debt for purposes of the earnings stripping rule. Except as provided by regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures the payment of another's obligation. The proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993, without regard to when the underlying loan agreement was executed.

2. *TEI Position*. TEI submits that the interest disallowance rule should apply only where the transaction presents a possibility of earnings being "stripped." Hence, section 163(j) only applies to interest that is not subject to U.S. income tax on the payee/recipient. If, for example, a domestic corporation pays interest to its foreign parent that is subject to the 30-percent withholding tax, section 163(j) is inapplicable. In such a case, no earnings have been "stripped" from the United States without taxation and the domestic subsidiary's interest expense is properly deductible.

Similarly, where a U.S. subsidiary of a foreign parent corporation borrows from a U.S. bank (or other taxable third-party lender) and pays interest on the loan to the U.S. lender, there is no earnings stripping, regardless of whether such loans are guaranteed (or otherwise supported) by the borrower's foreign parent. All of the interest paid to the U.S. lender is fully subject to U.S. income tax. TEI submits that section 163(j) should not be expanded to deny an interest deduction to the U.S. subsidiary in such circumstances.

In addition, the President's proposal would discriminate against U.S. companies that are foreign owned vis-á-vis their U.S. competitors that are domestically owned. In either situation, indebtedness owed to U.S. lenders may be guaranteed by the corporate parent. Denying an interest deduction to a foreign-owned company might not only violate the anti-discrimination clauses of treaties with many countries, but would also represent bad tax policy.

When the earnings stripping provision was enacted in 1989, Congress expressed concern that the use of loan guarantees not be used to circumvent the application of the rule. It recognized, however, that loan guarantees were often given in the ordinary course of business:

> Some have argued that the House report's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings. The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course.[24]

This rationale remains valid today. Loan guarantees that are given in the ordinary course of business should not be viewed as a tax-avoidance device.

Finally, TEI objects to the retroactive nature of the provision. The proposed expansion of the earnings stripping provision would apparently apply to transactions that were entered into before December 31, 1993. Such retroactive application of the proposal is inequitable and unwarranted. The proposed effective date is especially improper in light of the generally prospective effective date of section 163(j) when it was enacted.

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[24] H.R. Rep. No. 101-386, 101st Cong., 1st Sess. 566 (1989).

TEI therefore opposes the enhancement of the earnings stripping provision.

Enhancement of Accuracy-Related and Preparer Penalties

1. *President's Proposal.* Under section 6662, a taxpayer may generally avoid the accuracy-related penalty (for either substantial understatement of tax liability or negligence) for an underpayment of tax attributable to a position taken on a tax return if the position is not frivolous and is adequately disclosed. If the position is supported by substantial authority, disclosure is not required to avoid the penalty.[25] Similarly, the income tax return preparer penalty under section 6694 will not be imposed for an understatement of tax attributable to a position taken on a return if the position is not frivolous and is adequately disclosed. In the absence of disclosure, the penalty may be imposed if the position did not have a realistic possibility of being sustained on the merits and the preparer knew or reasonably should have known of the position. With respect to both penalties, a "frivolous" position is defined as one that is patently improper.

The President's proposal would substitute a "reasonable basis" standard for the "not frivolous" standard in both the accuracy-related penalty and the preparer penalty. "Reasonable basis" would be defined as a standard that is significantly higher than "not patently improper," thereby requiring that a return position be stronger than merely arguable or colorable in order to avoid the penalty. As a result of the change in standard, a taxpayer could avoid a substantial understatement penalty by adequately disclosing a return position only if the position had at least a reasonable basis; similarly, the penalty for disregarding rules or regulations would not be excused by disclosure unless the taxpayer's position had at least a reasonable basis. Finally, the requirement that a taxpayer disclose a position in order to avoid the negligence penalty would not be necessary because a taxpayer having a reasonable basis for its position would, by definition, be treated as not having been negligent. With respect to preparers, a penalty could be avoided by disclosure only where the position disclosed had at least a reasonable basis.

2. *TEI Position.* TEI has been concerned about the scope and proper application of the accuracy-related penalty since its enactment in 1982. We were thus pleased to participate in, and generally satisfied with the results of, Congress's 1989 reform of the Code's penalty provisions, which confirmed that the goal of penalties should not be to generate revenue but rather to encourage compliance by punishing culpable behavior. We believe Congressman Pickle should be applauded for his leadership role in crafting the Improved Penalty Administration Compliance Tax Act. We also believe the Internal Revenue Service should be commended for adopting a more customer-oriented approach to penalty administration.

Based on our long involvement with the accuracy-related penalty and with penalty administration generally, we are concerned about the inclusion of the accuracy-related proposal as a revenue raiser in the President's economic package. Nevertheless, as the professional association of in-house tax professionals who subscribe to rigorous Standards of Conduct, TEI *supports* the President's proposal to replace the "not frivolous" standard with the "reasonable basis" standard. Taxpayers and the IRS have experience with the proposed standard (which previously governed the application of the negligence penalty without regard to whether a position was adequately disclosed), and we believe the adoption of the standard would reduce the amount of "hair-splitting" that may occur with the "not frivolous" standard. Another beneficial aspect of the proposal is its application of the same standard to both preparers and taxpayers.

Notwithstanding TEI's support for the President's proposal, we believe Congress must underscore the need for the IRS to fairly apply the reasonable cause exception of section 6664. Specifically, in the proper exercise of its oversight responsibilities, the Committee should instruct the IRS to confirm that the reasonable cause exception can be met without requiring the taxpayer to be omniscient — to recognize that not every error requires the assertion of a penalty. In other words, they should distinguish, as Oliver Wendell Holmes said even dogs do, between someone who kicks them and someone who simply stumbles over them. A taxpayer should not be penalized for stumbling, especially given the complex state of today's tax law.[26]

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[25] **In addition, section 6664(c) provides that an otherwise applicable penalty will not be imposed if the taxpayer can demonstrate that there was reasonable cause for the understatement of tax and that the taxpayer acted in good faith.**

[26] **TEI is especially concerned about the application of the reasonable cause exception to large, multi-divisional companies. We believe that the IRS needs to give due weight to the taxpayer's effort to self-assess the proper tax liability,**
(continued...)

For the foregoing reasons, TEI supports the President's proposal to amend the accuracy-related and preparer penalty provisions and recommends that the IRS be instructed to revise its regulations to properly implement the reasonable cause exception of the 1989 penalty reform act.

Service Industry Non-Compliance Initiative

1. *President's Proposal.* Under current law, payers must generally file information returns with respect to persons to whom they have made annual payments of $600 or more in the course of the payer's trade or business. Treasury regulations generally exempt payments to corporations from this requirement. The President's proposal would eliminate the exemption in respect of payments to corporations.

2. *TEI's Position.* TEI shares the Administration's and Congress's concerns about the level of noncompliance and pledges its best efforts in assisting the IRS and Congress to design initiatives to attack noncompliance without imposing undue costs on either compliant taxpayers or the IRS. In this regard, we have over the last year held several meetings with IRS officials as well as with appropriate congressional aides on the general issue of corporate information reporting.

Based on our analysis, we must express significant reservations about the President's proposal, especially since it would be effective with respect to all payments made after 1993. We submit that the proposal to require the filing of Forms 1099 in respect of service payments to corporations would impose substantial costs and yield little benefit to the tax administration system. Our concerns — which could be either abated or heightened as more details are released — go not only (or primarily) to the potential effect of the proposal on our members as payees (recipients of the information returns), but rather to the tremendous burdens the proposal would impose on our members as payers.

Let there be no mistake: the target of the Administration's proposal to require the filing of information returns on payments to corporate service providers is *not* the large and medium-sized corporations whose members belong to TEI. Nearly all the companies represented by our membership are subject to continual, or at least regular, audit by the Internal Revenue Service; are subject to rigorous internal controls to forestall the nonreporting of income;[27] and have their financial statements certified by independent auditors. The IRS and the General Accounting Office both acknowledge that larger corporations are extraordinarily compliant with respect to service payments and, indeed, other categories of income. Notwithstanding the high compliance level of the large corporations, the proposal would "deputize" payers to collect, prepare, and file information returns on payments to corporate service providers. The imposition of such a mandate — which would extend to payments made by nonprofit organizations, state and local governments, and even the smallest company — would spawn significant administrative costs. Payers would have to change their accounts payable systems (which could involve both hardware and software changes), designate and train staff to perform the data entry tasks, and absorb the cost of preparing the necessary reports and sending them both to payees and the IRS. For example, accounting systems in many (if not most) companies do not distinguish between payments for services and other payments; all that is recorded is the account payable. Under the Administration's proposals, payers would be required to change their systems to differentiate between the two types of payments. Regrettably, such a task is not as simple as "flipping a switch."

Given the Joint Committee on Taxation's revenue estimate for the proposal — $326 million (as opposed to the Administration's $6.35 billion estimate) — TEI believes there is a strong possibility that the cost to the payer community would exceed the revenues flowing to the Treasury. Obviously, it is difficult to predict either the cost of the programs or how much revenue it would

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[26] (...continued)
taking into account not only the complexity of the rules with which the taxpayer must grapple, but also the operational constraints under which the taxpayer operates. In other words, the inquiry should focus on whether the taxpayer establishes reasonable business procedures (*i.e.*, acceptable internal controls) to ensure compliance with its obligation and then makes a good faith effort to ensure those procedures are followed. The failure of a non-tax employee to abide by the company's procedures should not give rise to a penalty.

[27] Publicly held companies in particular have no incentive to underreport income for financial reporting purposes. Moreover, financial controls mandated by the Securities and Exchange Commission represent a clear "audit trail" for IRS examiners to confirm that income is correctly and completely reported.

generate because so few details have been released. Based on the sketchy information that has been released, more than one company has already estimated that its costs would exceed $1 million to implement the proposed changes and that it would cost nearly that much to maintain the new system on an ongoing basis. Whether any exception — for example, for corporate payees whose gross receipts exceed a certain threshold or that are subject to continual audit — could significantly reduce the burden on payers remains unclear.[28]

The burdens that the proposal would impose on corporate payees should also not be underestimated. Corporations that receive the Forms 1099 would have to store them, and the proposal raises the specter that payees might be compelled to formally match, or reconcile, the amounts so reported to their books of account or their tax returns — a process that the IRS acknowledges could lead to countless mismatches, especially where the payee is an accrual basis or fiscal-year taxpayer (receiving information returns prepared on a cash, calendar-year basis). The situation is further complicated where the payments are received by a subsidiary but reported on the consolidated return filed by the corporate parent. These considerations have led the IRS in the past to oppose a broad-scale information reporting system; we suggest they apply with equal force to the "limited" program proposed by the Administration.

Equally important, there continues to be no convincing evidence that the IRS would be able to process the millions of additional pieces of paper that would be generated under the proposal.[29] In this regard, it is interesting to note that one aspect of the proposal — an IRS initiative to assist payers in verifying the taxpayer identification number of payees — has apparently been abandoned because the IRS cannot establish the program on schedule. There is no similar sympathy demonstrated, however, for the payers that would have to modify their computer systems and otherwise get geared up for the information reporting program.

As stated at the outset, TEI is committed to working with the government in attacking noncompliance in respect of service payments. We submit, however, that the burden of the compliance initiative should not be cavalierly imposed on compliant payers or on payees that have already demonstrated an extraordinarily high level of compliance.

For the foregoing reasons, Tax Executives Institute continues to have strong misgivings about the Administration's service industry non-compliance initiative.

Conclusion

Mr. Chairman, Tax Executives Institute appreciates this opportunity to present its views on President Clinton's Proposals for Public Investment and Deficit Reduction, and would be pleased to answer any questions you may have about its positions. In this regard, please do not hesitate to call Robert H. Perlman of Intel Corporation, TEI's President, at (408) 765-1202 or Timothy J. McCormally, the Institute's General Counsel and Director of Tax Affairs, at (202) 638-5601.

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[28] The Administration's proposal states that "some payors have suggested that it would be less burdensome to report all payments [for services], rather than to except payments made to corporate service providers [as allowed by current law]." Based on the corporate representatives whom we have heard from, that "suggestion" represents at best a minority view.

[29] Our understanding is that the IRS believes between 20 and 25 million additional information returns would be required to be filed under the President's proposal. Anecdotal information received from our members strongly suggests that the IRS's estimate is considerably understated.

Chairman ROSTENKOWSKI. Mr. Murphy, your entire statement will be included in the record. You are all aware, of course, that the President vetoed what was incorporated in two earlier bills as a tax simplification measure. Are any of you opposed to anything in the tax simplification measure that was introduced that the President vetoed on the last two occasions? I gather from most of your testimony that you are interested in tax simplification.

Mr. O'Neill, you point out in your testimony that the Tax Reform Act in 1986 attempted to reduce economic distortions and to eliminate tax sheltering opportunity. As you also recognize, the administration's plan raises individual tax rates but leaves the maximum rate on capital gains at 28 percent, thus creating a significant differential. What effect do you think this will have on the tax shelter activity?

Mr. O'NEILL. With the other limitations that have already been imposed, including the passive loss limitations, I am not sure that in and of themselves there will be that much of an impact on what I will call traditional tax shelters. I think it is very clear that with the rate spread that we are looking at that complexity will be reintroduced in connection with transactions because people will want and will plan their affairs and try to come within the lower capital gains rate. Therefore, to the extent you consider the capital gains rate as a shelter, yes, obviously the proposals will have an impact there.

Chairman ROSTENKOWSKI. Mr. Murphy.

Mr. MURPHY. Mr. Chairman, back on your point about H.R. 13, TEI did submit comments and there were some areas that we had concerns about. But we applauded the overall simplification initiative.

On your question about tax shelters, TEI has not weighed in on the capital gains provision or on the investment credit. But I have to tell you from my experience of 10 years as a district director in Iowa and in Georgia, I spent the good part of that time dealing with what we referred to at that time as abusive tax shelters. I would only point out where you have the combination of capital gains rate differential with such things as the investment credit, it certainly should bring caution back to those of you that are considering this, as well as to the IRS and the administration.

Mr. O'NEILL. Mr. Chairman, I would also like to go back to the comments about the simplification bill. I believe my predecessor testified before you on a couple of occasions about the proposals last year, and we generally supported them, but as Mr. Murphy's comments suggest, there may have been a few particular provisions that were of some concern to us, so I don't want the record to indicate that we were wholeheartedly in support of everything that was there. Certainly we support the vast majority of the provisions in the simplification bill.

Chairman ROSTENKOWSKI. Thank you.

Mr. Murphy, you expressed misgivings about a number of the revenue-raising provisions in President Clinton's budget. Do you support the President's goal with respect to deficit reduction, and if you do, how would you make up the revenue if you could remove the provisions you dislike but still meet the President's deficit reduction goals?

Mr. MURPHY. Mr. Chairman, in my written testimony we did make very positive statements about the President's proposals on deficit reduction. In the items that we commented on where we had serious opposition, I don't believe, with all due respect, that the dollars involved are all that substantial, although with a million dollars here, and a million dollars there is still big money.

As far as TEI's position on each one of those items, we had to deal more with tearing away the cornerstones of the Internal Revenue Code. As far as having suggestions for additional revenue raisers, I do not have any at this time, but I can assure you, Mr. Chairman, that our board of directors is coming to Washington this weekend, and we will be discussing in more depth the President's proposals, and we will be very pleased to present to you our additional thoughts.

Chairman ROSTENKOWSKI. If you would like to share that with us, I would like to see it.

Mr. Gordon.

Mr. GORDON. Mr. Rostenkowski, if we could go back to your prior question on tax shelters, I would like to say it has been our experience that the environment has changed, that many taxpayers have been burnt by having invested in tax shelters. They are now still paying the cost of having some of those shelters turn around. Even though there will be an incentive between the difference in tax rates, I think the drive to go into tax shelters per se will probably be a lot less than it was in the 1980's.

Chairman ROSTENKOWSKI. Mr. Kleczka.

Mr. KLECZKA. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. I had a question of Mr. Gordon related to the same subject having to do with the capital gains tax.

You mentioned that you and the New York CPA's were in favor of the capital gains tax differential if it could be made as simple as possible. Exactly what does that mean in terms of simplification? What is it that ought to be done to make that pass the simplification test?

Mr. GORDON. The particular provisions that we are referring to are the incentive provisions and talking about getting capital gains for the investment in small businesses in particular holding the property for 5 years, having a limitation of $1 million or 10 times your net investment, and there were certain other modifications. We felt they were making too many provisions in here which add to the complexity, that they had a cap of the companies only having $25 million in equity.

We felt that was enough of a restriction to stop people from really abusing the section, and that they had just said effectively that you have held the property for 5 years, and compute the excludable capital gain the way you normally would which is to take the amount you realize versus your cost basis and treat that as a capital gain. That would, in effect, accommodate the President's wishes about having an incentive for people to invest in small businesses, have them hold for a period of time to keep the capital in place and at the same time not add a lot of other complexities to the tax laws.

Mr. GIBBONS. Mr. Payne.

Mr. PAYNE. Thank you. One other question.

Mr. Podolin, you mentioned the complexity of the incremental ITC, and that it would be much better to have it direct rather than an incremental ITC. If in fact we pursue an incremental ITC, what are some of the practical difficulties associated with making that work?

Mr. PODOLIN. If you pursue an incremental?

Mr. PAYNE. An incremental ITC.

Mr. PODOLIN. Let me look at the proposal and try to answer it that way.

Mr. PAYNE. In other words, wouldn't it be difficult in establishing the baseline for all these proposals?

Mr. PODOLIN. In establishing the baseline, in identifying the used property and new property, and—let's see, identifying the amounts that qualify, the types of assets that qualify, classifying them by the category of depreciation years that they qualify for, I would have to look at it more closely, but it is a whole host of definitional issues.

Mr. PAYNE. Mr. Gordon, did you have anything to add.

Mr. GORDON. Yes, Mr. Payne. In particular, I would point out that to have to go back and recapture this information that is 2 years or 4 years old would be very difficult for a lot of our corporations. The records would not be kept in a form that would necessarily make it easy to extract this type of information.

So if you had to go back to a 4-year base and see which of the qualifying assets, it would require, again, a make-work type project.

We are also on record that imposing such a system, we think, does penalize companies that were, in effect, positive about our economy and were willing to make investment at a time when the payback was not seen right away; and we think this should be encouraged, not discouraged.

It is again good to encourage people when we need help the most. And to go back now and say to these companies, well, you invested, you had faith in the economy, and now we feel you are going to get less benefits than your competitors who held back, we think, is patently unfair.

Mr. PODOLIN. I would simply add, if I may, Mr. Payne, if you would look at our written testimony, I mentioned in my oral testimony a few minutes ago that the 7 percent for the most typical user of the incremental credit really works out to about 2 percent. And I don't think we have the time to go through that, but that calculation is in there.

So we are really talking about a great deal of administrative effort and cost to come up with a relatively modest benefit to the typical taxpayer.

Mr. PAYNE. Thank you.

Mr. KLECZKA [presiding]. Mr. Hancock.

Mr. HANCOCK. I just have one question for Mr. O'Neill. I'm reading your testimony—I was not here when you made your formal presentation—but you say that the broadening of the tax base has meant many people with significant income pay a higher effective tax rate on their income than they did before tax reform.

That is a little different from what we have been hearing around here, that the so-called rich have not been paying their share. Would you like to comment on that?

Mr. O'NEILL. I think the genesis of that comment is that many taxpayers who planned their affairs quite legally, through investing in tax shelters that were then permitted and the like, had very low effective rates. The 1986 act, through the passive loss limitations and other limitations, resulted in taxpayers who, for example, had been paying maybe at a 5 or 10 percent effective rate now having to pay 28 percent or at least the AMT rate.

The comment also addressed the perception of fairness; and there were clearly people who did not invest in shelters, and so their rates were significantly reduced. But there were a lot of people who quite legitimately had invested in tax shelters and had otherwise taken advantage of provisions in the Internal Revenue Code to reduce their effective rate to a very, very low amount; that has now been eliminated.

Mr. HANCOCK. That does make it a little bit different from what we have been hearing from many sources, which is that the rich got richer and the poor got poorer.

It does appear, though, that the President's plan and how it treats the capital gains and also the investment tax credits and also the personal income tax rates is going to be very damaging to small businesses, subchapter S corporations, and also to the individual partnerships and sole proprietorships as far as their ability to reinvest or to invest in additional jobs.

Would anybody like to comment on that?

Mr. O'NEILL. I think the expertise of the tax section goes more to analyzing technical issues than these broader policies, so I will beg off commenting on some of the economic implications, sir.

Mr. HANCOCK. Well, the fact remains, though—and you have the people with the tax association and what have you—that the President's proposed plan would increase the rate of taxation considerably on subchapter S corporations and sole proprietorships, which is where the jobs will be created in the future, at least the best possibilities of job creation.

Have you been hearing this from your association members?

Mr. O'NEILL. No, sir, we have not.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. KLECZKA. Mr. Reynolds is recognized for 5 minutes.

Mr. REYNOLDS. I don't have any questions.

Mr. KLECZKA. Mr. Brewster.

Mr. BREWSTER. No, sir.

Mr. KLECZKA. Mr. Jefferson.

Mr. JEFFERSON. Yes. May I ask a general question?

I didn't hear all the testimony. I have tried to take a quick survey of it, and I did listen to you, Mr. Murphy; I was here for your comments. You talked a lot about the complexity that would be introduced by the acceptance by this committee and ultimately by the Congress of certain provisions that are proposed in the President's plan, but you did not talk about another feature that he is trying to reach and that is the idea of fairness in the system.

I suppose this business about disallowing deductions for the millionaires, and increases in corporate taxes and such-and-such at

the higher levels is all about trying to at least have people feel there is an element of fairness in the plan, so that everyone is touched and so that some of what some people think were unfairnesses, inequities, if you will, have been addressed.

If they are to be addressed in the way the President talks about, can you discuss how this issue of fairness might be dealt with, assuming you think it is an issue?

Mr. MURPHY. Well, Mr. Jefferson, I certainly agree that fairness is an issue, and you can come to the issue from many different perspectives. My remarks were aimed more at the reaction of the corporate community. The first example that comes to my mind on fairness is the proposal by the President that individuals with higher incomes pay more tax.

I think the proposal to——

Mr. JEFFERSON. You would support the individual income tax increases.

Mr. MURPHY. To me, the increase in individual income tax rates, in addition to raising the revenue, is an indication by the President that he is trying to establish a higher level of fairness in the tax system—that those that make more should pay more.

In the corporate community, though, Mr. Jefferson, fairness means much more than the tax rate. When business is set up, if you are going to earn income, it has always been the case that any expenses related to that income should be deducted in arriving at your base for determining tax. If my testimony indicated anything other than that, then I did not express myself properly.

As far as giving other examples of fairness, I would only say that fairness also applies in a very complex business community where you have multinational corporations and large businesses that are dealing throughout the world. That is why I said that there seemed to be a reluctance to admit that the economy has no boundaries when it comes to trying to increase market share and trying to be successful in business, which would produce jobs; I am sure we both agree on that.

I don't know if that answers your question, but that is what comes to my mind.

Mr. JEFFERSON. Yes, thank you. I want to ask another one, which is more general and really more conceptual; and I don't even know if it is a practical alternative, but there is a lot of discussion now about, since we have this window of revisiting the time where we collect taxes for the Government—not so much collect income tax, but what our system ought to be—should it be a business transfer tax, should it be a VAT tax, or this, that, or the other?

Do you think this is the time to look at the entirety of the way we do our business in terms of financing our government, or should we stay wedded to the income tax or look at the business income tax or some other variation of the consumption tax?

Mr. MURPHY. I believe, Mr. Jefferson, that we are. Two years ago Tax Executives Institute's Consumption Tax Committee undertook a study of the value-added taxes around the world, and the results of the study were published right after the election. In fact, I hold up the book that was provided to all members of the Ways and Means Committee.

We did not take a position on a VAT, but our analysis gets right to your point that this country has to consider other ways of raising revenue, which goes back to the global economy again. As far as taking a position as to one or the other, a general sales tax or a type of consumption tax or even the energy tax that is in the proposal, TEI has not taken a position.

Mr. GORDON. Mr. Jefferson, if I can give one caveat why I think this should be looked at, let us not forget history. In 1986, we made vast changes in the tax rules, and it destroyed a number of businesses and, in effect, turned our economy.

I think before we make any massive changes, we have to first look to see how many people have planned businesses on them and give them time to react to such changes in our system. Corporations have made decisions based upon the tax laws as they perceive them to be, either currently or in the future. If we completely change our method of taxation, obviously this could have some very strange and some very harmful effects upon our economy.

Before we do something like that, we ought to have at least enough lead time so that people can adjust and make sure we are not, in effect, harming ourselves beyond repair.

Mr. PODOLIN. I would agree, Mr. Jefferson, with the concept that now is the time to take a hard look at the entire tax system in the United States, which doesn't mean that the AICPA endorses any sort of major change at this time, but we endorse studying it.

And, in fact, we have a task force that is also looking at a variety of options, such as a value added tax and other consumption-related taxes and so on. We have also recently published a document relating to integrating the corporate and individual income tax, and we can make that available to you as well.

Mr. JEFFERSON. Thank you. My time is up; I have a red light.

Mr. KLECZKA. Let me thank this panel for their testimony.

At this point we will call our next panel, starting with Julie Gackenbach from the U.S. Chamber of Commerce; Paul Huard, the National Association of Manufacturers; J. Roger Hirl from the Chemical Manufacturers Association; and Michael J. Fleming, from the Equipment Leasing Association of America.

Your testimony will be made a part of the official committee record, without objection, and we will start with Ms. Julie Gackenbach. Please correct me if I am mispronouncing the name.

Ms. GACKENBACH. Gackenbach. Close enough.

Mr. KLECZKA. Pretty close. Try Kleczka sometime.

STATEMENT OF JULIE LEIGH GACKENBACH, DIRECTOR, TAX POLICY, U.S. CHAMBER OF COMMERCE

Ms. GACKENBACH. Mr. Chairman and members of the committee, good morning. I am Julie Gackenbach, and I am the director of tax policy for the U.S. Chamber of Commerce. The Chamber of Commerce is the world's largest business federation, representing 215,000 members; and on behalf of our local and State chambers, businesses and associations, we appreciate the opportunity to present our views to this committee.

As you are aware, the legislative language for the proposals is not yet available, and as we understand, certain modifications may be made to individual provisions; therefore, it is difficult for the

Chamber at this time to assess the effect of certain individual provisions or the package as a whole.

We would advise the committee, we have some serious concerns about the Btu tax, increased corporate and individual income tax rates, and provisions affecting international business. The Chamber and its policy committee certainly want the opportunity to look at these proposals in much greater depth when the final results are released, and my comments today should be viewed in that context.

The President merits our support for having focused the Nation on the need to reduce the Federal deficit. And he is on point in asserting the deficit is sapping the ability of our Nation to make vital investments in education, retraining, jobs, productivity and economic growth. The Chamber unequivocally supports the goal of deficit reduction and urges the committee and the Congress to move with deliberate speed toward enactment of an immediate plan.

However, it is the nature of the political process that every organization will be differentially affected by the specifics of the proposal. This is particularly true at the Chamber, which represents large, medium and small businesses in virtually every sector of the economy. As we have said in that regard, our policy committees are reviewing the details.

Our goal is to work with this committee, the Congress and the administration to improve the negative aspects, preserve the beneficial and support a comprehensive measure reducing the deficit while preserving the fragile economy. Our members are concerned over the burden that the Federal deficit places on the economy; and while we are supportive of deficit reduction, we are concerned that the plan, as presented, relies too heavily on revenue increases to achieve this goal.

The Federal deficit is rooted in runaway deficit spending, and our members have long recognized the fact that Federal revenue is not the problem, but that ever-increasing levels of Government spending is. We believe that by significantly reducing Federal spending, which diverts resources from their most productive uses in the private sector, we can reduce the Federal deficit and increase the long-term rate of growth in our economy.

A lack of Federal revenue is not responsible for our deficit, and since revenue is not the problem, as history clearly demonstrates, tax increases alone will not solve the problem. As we have stated previously, what concerns us most in the current proposal is the heavy reliance on revenue enhancement.

We are particularly disturbed by the aspects of the proposals that rely on retroactive tax increases in exchange for future spending reductions. Based on past experience, taxpayers are reluctant to support higher taxes in exchange for promises of future spending reductions. Time and again taxpayers have seen increased taxes used, not for deficit reduction but to fund ever higher levels of government spending. This must not happen again.

One particular item we would like to bring to the committee's attention today, in the proposal, is the effect of the proposed increase in the individual tax rates on S corporations. As other witnesses have told you, currently the Nation has over 1.5 million businesses in this country operating under S corporation status. The vast majority of these businesses are small in every sense of the word.

They are the engines of our economic recovery, but the change in the individual tax rates will be particularly punitive to these corporations.

For them, their maximum tax rate will increase 8.6 percentage points at the top rate, an increase at $250,000, thus taxing the very retained earnings these small S corporations rely on to invest and grow. We are particularly concerned that this is retroactive, and we urge the committee to look at this proposal.

One idea we have supported is capping the rate of tax on the retained earnings in the S corporation at 31 percent. We have provided the administration with details of this proposal and will be happy to work with the committee.

In conclusion, Mr. Chairman, we are also very supportive of—and I see my time is running out—the investment tax credits. We are pleased to see the President did include them. Like other witnesses before you, we are concerned about the incremental nature of the investment tax credit, particularly the administrative burdens that it places.

In conclusion, Mr. Chairman, we would like to work with the committee and the Congress to achieve the goal of deficit reduction and designing an effective package. We believe that that should be done, though, to the maximum extent possible, through meaningful and enforceable spending restraints.

Mr. KLECZKA. Thank you very much.

[The prepared statement follows:]

Statement of the U.S. Chamber of Commerce

before the

House Committee on Ways & Means

on

President Clinton's Economic Proposals

by

Julie Leigh Gackenbach

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Mr. Chairman and members of the committee, good morning. I am Julie Leigh Gackenbach, Director of the Tax Policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation representing more than 215,000 members. On behalf of the Chamber Federation of local and state chambers of commerce, businesses and associations, we appreciate this opportunity to present our views on the revenue provisions of President Clinton's economic and deficit reduction plan. I have provided the full text of our comments and am requesting that they be included in the hearing record.

As you are aware, the legislative language for the President's proposals has not yet been made available and; as we understand it, modifications are being made to certain components even as we speak. Therefore, it is difficult for the Chamber, at this time, to assess the effect of either individual provisions or the package as a whole. The Chamber and its policy committees certainly want the opportunity to look at these proposals in greater depth when the final details are released. My comments today should, therefore, be viewed in this context.

The President merits our support for having focused the nation on the need to reduce the federal deficit. He is four square on point in asserting that the deficit is sapping the ability of our nation to make vital investments in basic education and retraining, jobs, productivity, and economic growth. The Chamber unequivocally supports the goal of deficit reduction and urges the committee and Congress to move with deliberate speed toward enactment of a meaningful plan.

Our members are concerned over the burden that the federal deficit places on the U.S. economy. While we are supportive of the goal of deficit reduction, we are concerned

that the plan as presented relies too heavily on revenue increases to achieve its goal. The President's package would have reduced federal spending 70 cents for each new dollar of federal revenue. The budget resolution as reported from the House Budget Committee narrows that gap by proposing $1.07 in spending reductions for each $1 of taxes. We are pleased that the budget resolution proposes $63 billion in additional cuts, but we believe that more can and must be done. Admittedly, this is no easy task, but we firmly believe that meaningful deficit reduction can only be achieved through spending restraint. Wasteful programs and spending on unauthorized programs must be curtailed. The growth in federal spending must be restrained and scarce tax dollars must more rationally be allocated among competing public needs.

Origins of the Problem:

The federal deficit is rooted in runaway spending. Our members have long recognized the fact that a lack of federal revenue is not the problem, and that ever increasing levels of government spending is. In each decade, from the 1950s to the present, government spending as a proportion of gross domestic product (GDP) has grown. Averaging 18.2 percent in the 1950, it grew to 23.2 percent in the 1980s. In 1993, federal spending is projected to hit almost 25 percent of GDP -- consuming nearly one-quarter of our nation's output.

Over the past two decades, government spending has grown faster than the U.S. economy. Despite a doubling of tax revenues throughout the 1980s, the federal government continues to run a persistently high and growing budget deficit. And because of the record tax hikes passed in 1990, direct tax burdens continue to increase, as do regulatory "taxes" on businesses forced to comply with costly mandates. This increasing burden of federal spending diverts resources from their most productive use in the private sector. Since 1988, federal spending has grown at an average annual rate of 8 percent and projected spending in 1993 will be a full four years ahead of an equivalent amount of revenues. Revenues won't hit this year's spending amount until 1997. In the coming years projected spending growth far outstrips projected revenue growth, and the structural deficit continues to ratchet upward.

Comprehensive Strategy for Deficit Reduction and Economic Growth

To reduce the federal deficit and promote long-term economic growth, Congress and the Administration must work together to sharply reduce the rate of growth in federal spending. Spending must be reduced from 24 percent of GDP -- a peacetime high -- to rates far more conducive to stronger economic growth.

Over the long-term, the federal government must cut the growth in the fastest growing programs. The President's proposed budget, to be sure, contains a number of

spending reductions. Also, and as a consequence of his leadership and OMB Director Panetta's forthrightness, the budget proposal is less checkered with accounting gimmickry and unwarranted economic assumptions. This is forward movement which we applaud. In addition to the cuts suggested by the President, we believe that Congress should examine every account in the federal budget that is increasing in cost faster than federal revenues are increasing. By and large, these accounts will be entitlements such as social security and federal pensions. Also, we would expect to find some areas of domestic discretionary spending that are increasing in cost more rapidly than federal revenue.

These accounts having been identified, all growth should be limited to the rate of growth in federal revenues. In other words, the United States will allow no program to enjoy a disproportionate share of the growth in federal resources.

We suggest this approach for a number of reasons. First, by identifying out of control accounts, Congress will be able to focus on those parts of the federal budget most responsible for the deficit. Second, by adopting a formula, lawmakers avoid the moral and political pitfalls of picking winners and losers. Third, while some programs will have less money, none will be starved; and those that are in control, do not have to be sacrificed.

I might note here that *The National Chamber Foundation*, our research affiliate, will be releasing a study of federal accounts that are increasing in cost more rapidly than federal receipts and will have a report (with macro-economic projections) available for your consideration in the next few weeks. A separate NCF project, The Federal Spending Review Project, will attempt to use this data to identify accounts meriting consolidation; and in more extreme cases, repeal. This second part of the project is expected to take more time.

We firmly believe that by significantly reducing federal spending which diverts resources from their most productive uses in the private sector, we can reduce the federal deficit and increase the long-term rate of growth in our economy. A lack of federal revenue is not responsible for our ever increasing federal deficit. In fact, during the 1980s, as deficits mounted, tax revenues flowing into government coffers rose. Indeed, tax revenues flowing into government coffers have dropped below 18 percent of national income only four times in the last three decades and all four of those occasions were prior to FY 1978.

Since revenue is not the problem, as history clearly demonstrates, tax increases alone will not solve the problem. In the 1980s, lawmakers addressed the funding gap through no less than five revenue bills, three of which were specifically targeted to deficit reduction. The three deficit-reduction specific revenue enhancements are: (1) The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982; (2) The Deficit Reduction Tax Act (DRTA) of 1984; and (3) The Omnibus Budget Reconciliation Act of 1990. In addition to these three deficit-reduction specific enactments, Congress passed no less than three other meaningful revenue enhancing bills in the 1980s including: (1) increased social security taxes (1983); increased motor fuels taxes (1984 and 1990); and, increased excise taxes on beer, wine,

spirits, and tobacco (1990). Lastly, the Tax Reform Act of 1986, which was revenue neutral but only in the aggregate, financed individual tax rate reductions by increasing corporate taxes on a dollar for dollar basis. In short, it should be recognized that Congress has not taken a back seat on the deficit question and has addressed the revenue side with some regularity and in meaningful amounts.

We should not fail to learn from this history. The President's plan addresses deficit reduction primarily through revenue enhancement; and to a lesser, but still significant, extent through spending reductions. The Chamber believes that the President's proposal relies too much on revenue enhancement (which has been tried) and not enough on spending restraint (which has not).

The Chamber readily acknowledges the history of Congressional efforts to reduce federal spending. Those efforts, however unpalatable to affected lawmakers, have not been as significant as the revenue enhancements in the same period. The staff of the Senate Budget Committee, for example, reprised the deficit reduction measures of the 1980s and found that the average bill, once stripped of accounting gimmickry, blue smoke and mirrors, and when placed in the context of actual economic performance, cut spending by only $14 billion. The largest single bill cut spending by only $17 billion, this in direct comparison to the largest single tax increase in history passed in the same period which raised $165 billion.

Thus, it seems apparent that federal revenue is not the problem. This suggests that the President's program should focus more on spending cuts and less on revenue enhancement.

Revenue Enhancement

Although no one likes a tax increase, the Chamber realizes that some revenue enhancement may be included in a deficit reduction plan. Some members of the business community are willing to make a greater contribution and support an economic plan that includes spending cuts and revenue enhancement if the cuts are both meaningful and of sufficient magnitude to credibly suggest that the revenue:spending gap can be closed with a small amount of new revenue.

The Chamber does not believe that these conditions are far fetched. To his credit, the President has succeeded in focusing the nation on deficit reduction and has gained popular support for the type of hard choices that must be made in entitlements and elsewhere if we are to close the revenue:spending gap. This window of opportunity should not be missed. More to the point, if Congress is willing to make the hard spending choices then the Chamber will assess those choices and look seriously at a complete package, provided such a package will still preserve the economic recovery.

As we have stated previously, what concerns us most is that current proposals rely far too heavily on revenue enhancement to close this gap. A particularly disturbing aspect of the President's proposal is that it relies on **retroactive** tax increases and **future** spending reductions. Based on past experience taxpayers are reluctant to support higher taxes in exchange for promises of future spending reductions. Time and time again, taxpayers have seen increased taxes used not for deficit reduction but to fund ever higher levels of government spending. This must not happen again.

Overall, we note that the President's proposal raises taxes by $245 billion over five years. This is a significant number; indeed, if enacted, it will be the single largest tax increase in our history. Most of the new revenue will come from an across-the-board BTU tax; two-thirds of which will be paid by businesses, and one-third by individuals. A substantial amount will come from raising the top corporate tax rate to 36 percent, and the top effective individual rate to 39.6 percent.

As we previously mentioned, the legislative language for the President's proposals has not yet been made available and; as we understand it, modifications are being made to certain components even as we speak. As such it is difficult for the Chamber to assess time, the effect of either individual provisions or the package as a whole. The Chamber has some serious concerns about the BTU tax, increased corporate and individual income tax rates and the provisions affecting international business. As we understand it, substantial modifications may be being made to these provisions. We want to look at these proposals in greater depth when the final details are released. Until such time as these details are made available, the Chamber offers the following preliminary comments.

Individual Rates and Subchapter S Corporations

Of particular concern to the Chamber Federation is the effect the proposed increase in the individual tax rates will have on Subchapter-S corporations. Currently, over 1.5 million businesses in this country operate as S corporations, the vast majority of which are small businesses in all senses. These businesses are the engines of economic recovery. In ordinary times, small business accounts for one-half of all new job creation, in times of recovery, this number jumps to 75 percent.

Enacted in 1958, Subchapter S of the Internal Revenue Code provides special rules for the tax treatment of certain small business corporations whose shareholders elect such treatment. A number of major modifications to the Subchapter S taxation rules were made in 1982, introducing additional concepts of partnership taxation and simplifying and liberalizing a number of eligibility rules. Under the Subchapter S rules, the income of eligible corporations is subject to taxation at the shareholder, rather than corporate, level and therefore subjected to individual, rather than corporate, tax rates. In this regard, the income of an S corporation will be subject to the increased individual tax rates.

This change, as proposed, will be particularly punitive to S corporations. For these companies, their maximum tax rate will be increased a full 8.6 percentage points, as opposed to the two percentage point increase in the C-corporation rate. Perhaps more importantly, the rate increase for S-corporations will be effective at only $250,000, while C-corporations will not experience higher rates until their income exceeds $10 million. Thus taxing the retained earnings of the S-corporation (on which they rely so heavily) at much higher rates, leaves them with less capital to invest, grow and create new jobs. We are also particularly concerned that, as proposed, this increase would be retroactive to January 1, 1993.

When originally enacted the one of the stated goals of the S-corporation provisions was to provide aid to small businesses by allowing income to be taxed to shareholders who might be in lower tax brackets than their corporation. The proposed rate increases would reverse this condition. The Chamber Federation strongly urges the Committee and the President to address this issue.

One solution to the problem would be to subject the undistributed earnings of Subchapter-S corporations to a maximum tax rate of 31 percent, thus placing a ceiling on the taxation of the accumulated earnings of the business. The non-business income would still be subject to the increased personal income tax rates. We have provided the Administration with the details of this particular solution and we will look at other ways to deal with this problem.

In addition, the Chamber, along with the American Institute of Certified Public Accountants, and the Tax Section of the American Bar Association, has developed a proposal to improve the Subchapter S provisions. Specifically, the proposal would:

- remove many of the traps for the unwary by:

  1) repealing excessive passive investment income as a termination event;
  2) placing S corporation's shareholders in the same position as owners of regular corporations with respect to fringe benefits;
  3) allowing a carryover of disallowed losses and deductions under section 465 for post-termination transition periods; and
  4) expanding the post-termination transition period until 120 days after a determination is made that the election had terminated in a prior year.

- remove many of the obstacles to capital formation by S-corporations by:

  1) permitting tax exempt organizations as eligible shareholders;
  2) allowing non-resident alien shareholders to own S-corporation stock;
  3) expanding the safe harbor debt to permit convertible debt;
  4) permitting shareholder personal guarantees of corporate debt to increase shareholder basis; and

5) permitting S-corporations to issue "plain vanilla" preferred stock with no convertibility and treat the stock as corporate debt for federal tax purposes; and

- preserve family ownership of small businesses by:

1) permitting those trusts owning S-corporation to have multiple income beneficiaries, accumulate trust income, and spray income among the beneficiaries; and

2) count all members of a single family who own S-corporation stock as a single shareholder.

We believe these proposals would eliminate needless barriers to S-corporation formations. We look forward to working with the Committee and the Administration to ameliorate the punitive provisions of the current proposal and to reform the Subchapter S rules.

Business Deductions

The President's proposal includes a number of provisions to limit or deny ordinary and necessary business expense deductions. The Chamber believes that such action would undercut a fundamental principal of taxation -- that businesses should be taxed on income, rather than gross receipts. In this regard, businesses should continue to be allowed to deduct all ordinary and necessary expenses. That lawmakers have already taken the first step down this slippery slope in limiting the business meal deduction to 80 percent of cost is hardly justification for compounding the error.

Investment Incentives

Some observers have suggested that the strength of the ongoing economic recovery argues against the need for a investment incentives. We disagree. The recession has created a structural gap in our economic performance meriting a strong response at the federal level. The President is absolutely right -- the recovery is not generating the type of high paying jobs that educate children, buy houses, purchase cars, provide for a secure retirement, and guarantee the American dream. We are pleased, therefore, that he has chosen to include several investment incentives in his deficit reduction package. We should not, however, labor under the impression that the President's plan adequately offsets the negative effect of prior enactments. Also, the value of these incentives to companies tax under the AMT is not fully offset by the President's plan to restore a measure of acceleration to class life depreciation schedules applicable to AMT ratepayers. At least, this is a small step in the right direction.

The Investment Tax Credit

Research clearly shows that investment in equipment is the single most important factor contributing to economic growth and development. Each one percent of GDP invested in business equipment increases the growth rate of GDP by one-third of one percent - an exceedingly high rate of return.

Tax devices lowering the tax burden on investment in equipment - especially the Investment Tax Credit (ITC) - deserve serious consideration. The ITC has been enacted and repealed seven times in the past 30 years and has been described as the B-1 bomber of tax policy. During periods in which the on-again-off-again ITC was in effect, growth in equipment spending rose strongly. Following the credit's repeal in 1986, the rate of investment in equipment slowed. This sharply lowered the rate of spending on industrial equipment for the decade as a whole and hindered the recovery from the recent recession.

Originally, the ITC was designed out of recognition that depreciation deductions against investments for tax purposes comprise less that 100 percent of assets' cost. Currently the average recovery rate for capital equipment assets ranges from a maximum of 88 percent for five-year equipment to no more than 56 percent for 15 and 20-year assets. This means that companies are not permitted to recover the full replacement cost of their investments in assets with class lives longer than one year. This creates economic distortion by raising the cost of capital. Since recovery rates are substantially less for longer-term investments than for shorter-term ones, the current tax code creates a significant bias away from longer-term investments.

During the many times the ITC has been in and out of the tax code, the motivation for its enactment has shifted more toward its perceived short-term economic stimulus effect. Thus, ITC proposals tend to be targeted, incremental and temporary. At best, these kinds of credits result in a temporal displacement of capital investment rather than an absolute increase in investment; and at worse, they actually increase distortions in the allocation of capital.

We are pleased that the Administration has included a permanent ITC for small businesses in its economic proposal. The credit will lower the cost of capital for these businesses, creating an added incentive for these firms to invest and grow. While we applaud this provision, we are concerned that the Administration chose to bifurcate the investment tax credit -- providing a permanent, non-incremental credit for small businesses and a temporary, incremental credit for all other firms.

Except for firms with revenues of less than $5 million eligible for the permanent ITC, the proposal, as described in the Treasury Blue Book, would allow taxpayers a credit equal to seven percent of the purchase price of assets above an arbitrary business investment base provided that the asset is placed in service between December 3, 1992 and December 31, 1994.

As a result of its design mechanisms, business will be eligible for an investment tax credit on only 50 percent of new investment. Under an "incremental" approach to the ITC, companies which have maintained higher levels of investment are penalized, *vis a vis* their competitors which are rewarded for their lack of investment by a lower base. Companies which have maintained substantial levels of investments in the past will likely resent rewarding their competitors who have let their investment slack.

An incremental ITC also is administratively problematical. Determining the base and administrating such a "floating" base would be difficult and complex. The Administration recognized these administrative problems and cited them as a reason for making the small business ITC non-incremental. Thus, we urge the committee to extend the non-incremental ITC treatment to all businesses on all eligible investments. In addition, for the majority of capital intensive firms who are subject to the AMT, the ITC as crafted would provide no added incentive. To encourage these firms to make additional investments, we recommend that the ITC be made fully creditable against AMT liability.

The Alternative Minimum Tax

As we mentioned, a majority of capital intensive firms are subject to the alternative minimum tax (AMT). The AMT has become, in effect, a complete and parallel income-tax system, posing complex and burdensome record keeping requirements and increasing the cost of capital for American businesses. For those subject to it, the AMT increases capital costs 15 to 20 percent and discourages investment in productive capital assets by negating many of the incentives, including accelerated depreciation, designed to foster capital formation and investment.

We are pleased that the President recognized the detrimental effects of the AMT and proposed to modify the current AMT depreciation system. Under the proposal, the depreciation calculation under the adjusted current earnings would be eliminated and for AMT purposes taxpayers would use a 120-percent declining balance method over regular tax class lives. This proposal represents a significant reduction in the record keeping burden of AMT taxpayers and is a first step toward restoring some of the incentive for investment provided by accelerated depreciation. We strongly urge the Committee to retain this provision, however, we urge you to reconsider the effective date of this provision. Given the retroactive effective date of the tax rate increases and the investment tax credit, we encourage you to make the provision to provide AMT relief also retroactive.

Research and Experimentation Tax Credit

The Chamber is pleased that President Clinton has proposed a permanent extension of the research and experimentation (R&E) tax credit. Industrial progress depends on the development of innovative products and methods. Research and experimentation conducted by business is the primary means by which innovation is generated. Scientific developments

are transformed into new products and processes that result in increased productivity, improved living standards and sustained economic growth. A permanent R&E credit will ensure that the U.S. remains the largest investor in absolute size regarding R&E expenditures and will ensure that American business remains competitive abroad.

Allocation of U.S. R&E Expenditures to U.S. Source Income

We are also pleased that the President has included a provision to make U.S. incurred R&E expenses 100 percent allocable to U.S. source income. Under current law, a U.S. corporation's foreign tax credit is limited to 34 percent of the company's foreign source taxable income. Sections 861, 862 and 863 of the Internal Revenue Code were created to define whether the source of income was within or outside the United States. Treasury regulation Section 1.861 requires that indirect expenses be apportioned to the sources of income. Presumably, if this defining process is property carried out, that which is U.S. source income will be taxed in the U.S. and that which is foreign source income will be eligible for the relief provided by the foreign tax credit mechanism.

The allocation of indirect expenses to foreign source income, without a corresponding foreign deduction, has the inherent effect of taxing the same earnings twice as a corporation runs up against its foreign tax credit limitation. Under the Tax Reform Act of 1986, multinational corporations are likely to face such a double-taxation scenario. This, of course, defeats the very purpose of the foreign tax credit, which is to prevent double taxation.

Double taxation results, or can result, depending on the particular circumstances, because the U.S. expenses allocated under the Section 1.861 regulations to foreign source income are not deductible in any foreign jurisdiction. No other country treats its domestic research and experimentation as if it were conducted elsewhere, and U.S. incurred expenses allocated to foreign source income are not deductible in foreign jurisdictions. Thus, a U.S. taxpayer in effect has its foreign tax credit limitation proportionately reduced to the extent that it conducts U.S. R&E.

The allocation rules are a disincentive to domestic research and experimentation. As a result, some companies have moved their R&E activities abroad. The Section 1.861 allocation regulations have discouraged domestic research, encumbered U.S. multi-national companies with higher overall tax burdens that those of their foreign competitors, and made it difficult, if not impossible, for companies to implement long-range R&E plans.

The Chamber believes that R&E expenses incurred in the U.S. should be 100 percent allocated to U.S. source income. We applaud the President for taking this action.

Passive Losses

The Tax Reform Act of 1986, in an effort to curb abusive tax shelters, subjected all rental real estate activities to the passive loss rules. Under current law, all rental real estate owners are deemed to be passive investors regardless of their day-to-day involvement in the real estate business. The result of this application is that real estate professionals are subject to tax on the gross income of their overall real estate operations and not on their net income, as other types of businesses.

There is no question that the passive loss rules have had a negative impact on all segments of the real estate industry. The resulting declines in asset values have exacerbated the problems of the nation's financial institutions and had spillover effects on the overall health of the economy. The President has proposed to amend the passive loss rules to eliminate this unfair distinction for rental real estate. The Chamber strongly supports this effort.

Conclusion

In conclusion, Mr. Chairman, the Chamber on behalf of its members urges the Congress to the maximum extent possible to achieve the President's goal of deficit reduction through meaningful and enforceable spending restraint. We look forward to working with the Committee, Congress and the Administration to design an effective deficit reduction package which preserves the recovery and enhances long-term economic growth.

Mr. KLECZKA. Mr. Paul Huard, vice president, taxation and fiscal policy department for the National Association of Manufacturers.

Mr. Huard.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman. On behalf of our 12,000 members, who account for more than 80 percent of U.S. manufacturing, employment and production, I am pleased to be here to discuss the revenue matters contained in President Clinton's proposals for economic stimulus and deficit reduction.

Before discussing specifics, I want to emphasize at the outset that NAM is fully supportive of President Clinton's deficit reduction goals. Just as importantly, the President has accurately described our need as a Nation for less emphasis on immediate consumption and more emphasis on the private investment so essential to productivity improvement and job creation.

Our great concern about the President's plan is that it won't work. One reason we think this will happen is that the plan relies far too heavily on tax increases to reduce the deficit and far too little on spending cuts. Another major cause for concern is, each dollar of business tax incentive in the President's economic stimulus proposals is offset with at least $3 of business tax increases.

Money is a fungible commodity, and the plain fact is that reducing business cash-flow by $113 billion over the next 5 years means less, not more, private sector jobs and investments. What will happen is, the planned business tax incentives, which are modest and to a significant extent only temporary, will be completely swamped by the plan's business tax increases, which are extremely large and in virtually every case permanent.

A related problem is whether, given evidence of a stronger-than-expected recovery, any short-term temporary stimulus is necessary at all. We think it might be better to abandon this effort, in particular the unworkable and nearly useless temporary incremental ITC, and reduce proposed tax increases by an appropriate multiple.

Let me emphasize that the NAM is not recommending inaction. We strongly support the President's goals of reducing the deficit and expanding economic growth, and want him to succeed in achieving them. If he is to do so, however, we believe his economic program must be reconfigured along the following lines.

First, a much greater effort must be made to reduce Government spending and, equally as important, to make the operations of Government departments and agencies, as well as the regulations they administer, more cost efficient. The ratio of spending cuts to tax increases must be significantly increased, at the very least 2-to-1 from its present level of 1-to-1.

Next, the proposed net tax increase on U.S. business is much too high. This must be drastically reduced. We think this would be best achieved in the following four ways:

One, by eliminating the proposed rate increases on business income, including not only corporate income but also the business income of individuals choosing to do business as sole proprietors, partners and subchapter S shareholders.

Two, eliminating the proposed Btu-based energy tax, which is, to a significant degree, a tax on industrial production rather than a consumption tax. This will have a severe adverse impact on energy-intensive industrial processes. This proposed tax would unilaterally increase the cost of U.S.-produced goods relative to foreign goods, thus impairing our competitiveness in both domestic and overseas markets.

Three, eliminating all proposals to limit or deny ordinary and necessary business expense deductions. Such changes would seriously erode one of the most basic and fundamental principles of sound income tax policy, that businesses should pay income taxes not, on gross receipts but on incomes-gross receipts less all expenses incurred in producing such receipts.

Four, eliminating inappropriate proposals to increase taxes on U.S. multinational taxpayers. These companies are able to provide domestic jobs only if they can remain competitive in today's global marketplace. Targeting such taxpayers for large tax increases related to their overseas operations will make them less competitive globally and thus reduce their abilities to provide U.S.-based jobs.

Finally, having recognized the need to increase the relative tax burden on consumption, the administration should follow through on this recognition by implementing a broad-based general consumption tax, such as a value added tax. We believe such a tax imposed at a uniform rate on the widest possible base of both goods and services is the simplest and fairest method of raising funds for deficit reduction across all social, regional and economic sectors.

Thank you, Mr. Chairman. That concludes my remarks.

Mr. KLECZKA. Thank you, Mr. Huard.

[The prepared statement follows:]

TESTIMONY OF
PAUL R. HUARD, VICE PRESIDENT
TAXATION AND FISCAL POLICY DEPARTMENT
NATIONAL ASSOCIATION OF MANUFACTURERS

ON REVENUE MATTERS IN
THE ADMINISTRATION'S PROPOSALS FOR
ECONOMIC STIMULUS AND DEFICIT REDUCTION

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MARCH 17, 1993

Thank you, Mr. Chairman. I am Paul R. Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers [NAM]. On behalf of our 12,000 members, who account for more than 80 percent of U.S. manufacturing employment and production, I am pleased to be here to discuss the revenue matters contained in President Clinton's proposals for economic stimulus and deficit reduction.

I. Overview and General Recommendations

Before discussing specifics, I want to emphasize at the outset that NAM is fully supportive of President Clinton's deficit reduction goals. We believe he is correct in concluding that significant reduction of the federal budget deficit is absolutely essential if we are to achieve long-term economic growth and prosperity and a rising standard of living for all Americans. Just as importantly, the President has accurately described our need as a nation for less emphasis on immediate consumption and more emphasis on the private investment that is so essential to both productivity improvement and job creation.

Our great concern about the President's plan is that it will fail to achieve its goals of reducing the deficit, creating jobs and increasing productivity-improving investments. One reason we think this will happen is that the plan relies far too much on tax increases to reduce the deficit, and far too little on spending cuts. While both spending cuts and tax increases will cause short-term economic contractions, spending cuts will result in smaller GDP losses and fewer job losses than an equivalent amount of tax increases.

Another major cause for concern is that each dollar of business tax incentive in the President's economic stimulus proposals is offset with at least three dollars of business tax increases. As shown in Table 1 in the Appendix, the proposed business tax incentives total slightly more than $56 billion over the period 1993-98. Over the same period, however, business taxes would be increased by about $170 billion. Money is a fungible commodity, and the plain fact is that reducing business cash flow by $113 billion over the next five years means less, not more, private sector jobs and investment. What will happen is that the plan's business tax incentives--which are modest and to a significant extent only temporary--will be completely overwhelmed by the plan's business tax increases--which are extremely large and in virtually every case permanent.

Because of this excessive reliance on taxing business rather than personal income, as well as the plan's overly high ratio of tax increases to spending cuts, the plan in our estimate just won't work. Our preliminary econometric analysis indicates that, if implemented in its present form, the plan will cost the economy 1.2 million jobs by 1998 and Gross Domestic Product [GDP] in that year will be $63 billion lower than if we do nothing at all.

Let me emphasize that NAM is not recommending inaction. We strongly support the President's goals of reducing the deficit and expanding economic growth, and want him to succeed in achieving them. If he is to do so, however, we believe his economic program must be reconfigured along the following lines:

A. A much greater effort must be made to reduce government spending and--equally as important--to make the operations of government departments and agencies, as well as the regulations they administer, more cost efficient. The ratio of spending cuts to tax increases must be significantly increased, at the very least to two-to-one from its present level of well below one-to-one.

B. The proposed net tax increase on U.S. business is much too high and is totally inconsistent with the President's goals of creating new jobs, increasing private investment and expanding economic growth. If the Administration's economic program is to succeed, the proposed increases in business taxation must be drastically reduced. This is best achieved by:

   1. Eliminating the proposed rate increases on business income, including not only corporate income but also the business income of individuals choosing to do business as sole proprietors, partners and subchapter S shareholders.

   2. Eliminating the proposed BTU-based energy tax which is, to a significant degree, a tax on industrial production rather than a consumption tax. Because of its severe adverse impact on energy-intensive industrial processes, this proposed tax would unilaterally increase the cost of U.S.-produced goods relative to foreign-produced goods, thus impairing U.S. competitiveness in both domestic and overseas markets.

   3. Eliminating all proposals to limit or deny ordinary and necessary business expense deductions. Such changes would seriously erode one of the most basic and fundamental principles of sound income tax policy: that businesses should pay income taxes not on gross receipts but on income [i.e., gross receipts less all expenses incurred in producing such receipts].

   4. Eliminating inappropriate proposals to increase taxes on U.S. multinational taxpayers. These companies are able to provide domestic jobs only if they can remain competitive in today's global marketplace. Targeting such taxpayers for large tax increases related to their overseas operations will make them less competitive globally and thus reduce their ability to provide U.S.-based jobs.

C. Having recognized the need to increase the relative tax burden on consumption, the Administration should follow through on this recognition by implementing a broad-based general consumption tax, such as a value-added tax [VAT]. We believe such a tax, imposed at a uniform rate on the widest possible base of both goods and services, is the simplest and fairest method of raising funds for deficit reduction across all social, regional and economic sectors.

In the balance of my testimony, I will elaborate on the general recommendations made above and address a selected number of the specific revenue proposals made by the Administration.

II. Rate Increases on Business Taxpayers

Corporate Taxpayers. Reducing the cash flow of corporations by nearly $31 billion over the next five years is no way to create jobs and spur additional investment. Further, it is totally unjustified as a matter of fairness. Corporations are already much more heavily taxed than individuals. In 1990, individuals had aggregate personal income of $4.6 trillion on which they paid federal income taxes of $466.7 billion, an average effective rate of 10 percent. Corporations, on the other hand, paid $117.4 billion in federal income taxes on total profits of $361.7 billion, an average effective rate of 32.5 percent. Thus, under the

existing federal income tax, corporations already pay a proportion of their income that is nearly triple that paid by individuals. The suggestion that corporate rates must be increased so that corporations pay their "fair share" is unwarranted, and wholly without foundation.

Another argument advanced in support of corporate tax increases is that corporate income taxes don't account for as big a share of federal revenues as they used to several decades ago. This argument, in a word, is specious, as the figures below clearly illustrate.

	1960	1990	Increase
Personal Income [% of total]	$409 billion [89%]	$4,664 billion [93%]	1,040%
Corporate Profits [% of total]	$ 51 billion [11%]	$ 362 billion [7%]	610%
Total	$460 billion	$5,026 billion	

Looking at changes in the combined total of personal income and corporate profits between 1960 and 1990, it can be seen that corporations' share of the total dropped by a little over a third, because profits grew at a much slower pace than personal income. It's no wonder, then, that the corporate income tax share of total revenues has also dropped significantly. To suggest that we need to remedy this with a corporate tax increase is a lot like saying that we ought to raise taxes on an individual whose annual income has dropped from $100,000 to $66,000, so that he can continue to pay just as much tax now as when he was making $100,000.

Moreover, the fact is that corporations--notwithstanding the fact that their share of national income has significantly decreased--still pay about as large a share of total federal revenues as they used to. This is because of the explosive growth of the federal payroll tax burden. Between 1960 and 1990, annual federal payroll tax receipts increased from about $14 billion to $380 billion. It is our conservative estimate that approximately one-third of total 1990 federal payroll taxes--about $127 billion--were paid by corporate employers. Adding this $127 billion to the $94 billion in corporate income tax receipts for 1990 gives a total of $221 billion, or about 22 percent of the total federal tax receipts of slightly over $1 trillion for that year. Given the fact that corporate profits are less than one-twelfth as large as personal income, this is more than a "fair share."

Individual Taxpayers. Many business taxpayers--virtually all of them small businesses--do not pay tax on their net business income under the corporate tax rate schedules. This is because they either are unincorporated and doing business as sole proprietors or partners or, if incorporated, are paying tax on this income under the individual rate structure pursuant to subchapter S of the Internal Revenue Code [Code]. The proposed increases in the individual rate structure will therefore reduce the retained earnings of such businesses, earnings that would otherwise be available for job creation or productivity-improving investment. We think it is essential that this problem be addressed. One approach would be to hold the top rate on the business income of individual taxpayers at its current level of 31 percent, using calculations similar to those employed under the pre-1981 maximum tax on earned income. Under such an approach, the non-business income of these taxpayers, such as interest and dividends, would still be subject to the new top marginal rate of nearly 40 percent.

III. BTU-Based Energy Taxes

NAM views the proposed BTU-based energy tax as an extremely unfortunate choice. Although it appears to be a well-intentioned attempt to tax consumption, in reality it would amount to a major tax on industrial production. Our preliminary estimate is that at a minimum one-third--and possibly more--of the total BTU tax would fall directly on industrial production processes, i.e., would increase the cost of the energy used by American manufacturing firms in making their products. Thus, the BTU tax would unilaterally increase the cost of U.S.-produced goods relative to foreign-produced goods, thereby impairing U.S. competitiveness in both domestic and overseas markets. And, there is no way to impose a comparable cost penalty on foreign-based production that would be

consistent with our treaty obligations under the General Agreement on Tariffs and Trade [GATT].

Our preliminary econometric analysis of the effect of the proposed BTU tax is that, by 1998, slightly more than 600,000 jobs will have been lost, and GDP will be $38 billion lower than otherwise. We think it is noteworthy that over half of the GDP and job losses associated with the Administration's economic program can be directly attributable to the proposed BTU tax, even though that tax represents well under a third of the tax increases being proposed.

The impact of a BTU tax would be extremely disparate, both by geographic region and by business sector. There are, for example, wide variations by state in the amount of energy used to generate a dollar of gross state product. It has been estimated that, on average, it takes 15,700 BTUs of energy to produce a dollar of state economic output. The range of energy intensiveness, however, is quite wide, running from 44,600 BTUs per dollar of output in Louisiana to less than one-fifth that amount--8,100 BTUs per dollar of output--in New York. The states that would experience the most adverse consequences from the BTU tax are listed in Table 2 in the Appendix. They are primarily in the South and West.

Variations in the impact of a BTU tax by specific business will also be enormous, as shown in Table 3 in the Appendix with regard to manufacturing firms. The largest use of energy per dollar of value added occurs in nitrogenous fertilizers (192.1 thousand BTUs per dollar), cement (150.7), petroleum refining (143.4), paperboard (96.3), blast furnaces and steel mills (95.9), and primary aluminum (65.3). On average, manufacturing firms consume 12,100 BTUs per dollar of value-added. By comparison, most services are much less energy-intensive. Since the BTU tax will therefore will fall more heavily on the manufacturing sector than on the service sector, it should be no surprise that we find this unfair and objectionable as a matter of basic principle. An even wider economic interest is at stake, however, because exports of manufactured goods account for over 80 percent of U.S. merchandise exports, and are three times greater than service exports. Manufacturing exports have in recent years accounted for 30 to 40 percent of U.S. economic growth.

For all the foregoing reasons, the BTU tax is a greatly inferior approach to taxing consumption. As I will discuss at greater length later in this testimony, NAM believes a far superior approach would be a broad-based general consumption tax such as a VAT.

IV. Limits on Business Expense Deductions

The Administration has proposed a large variety of changes which would either restrict, or in some cases deny outright, deductions for certain types of business expenses. Among the categories affected are executive compensation, business meals and entertainment, contributions to pension and profit sharing plans, lobbying expenses and club dues. I will not comment on the specifics of each category of deduction being attacked under the Administration's plan. This is because our strong opposition to each of these changes is grounded in basic principle and has little or nothing to do with the particular details of the deduction in question.

The basic principle in question is this: As applied to business taxpayers, the federal income tax has traditionally been understood to be a tax on net income, i.e., on gross income less deductions for all costs incurred in producing such income. Denial of a deduction for all or part of costs incurred in the ordinary course of a trade or business changes the nature of the tax system from a tax on income to a tax on gross receipts. Gross receipts constitute, in NAM's view, a wholly inappropriate and inequitable base for the imposition of federal taxes on business income, leading to widely disparate tax burdens among business taxpayers.

In some cases, such as the proposed deduction limits for executive compensation, additional objections apply. In that situation, for example, the proposed limitation would [1] substitute the judgment of the legislature in a matter properly reserved to shareholders and directors and [2] result in double taxation, since compensation for which a deduction is

disallowed would nonetheless be included in the gross income of the recipient.

Our fundamental objection to this entire group of proposed changes, however, is that they seriously erode the long-standing concept of the federal income tax as a tax on net business income rather than gross business income. These changes would continue a troublesome precedent that began in earnest in 1986 with the limitation of the business meals and entertainment deduction to 80 percent. What's next? 90 percent of rent? 80 percent of advertising? 70 percent of telephone charges? The slope gets very slippery very fast. All these proposed restrictions on deductibility should be dropped.

V. Tax Increases on Multinational Taxpayers

The President's plan proposes a number of changes that, in effect, would substantially increase the U.S. income taxes paid by U.S. multinational taxpayers with respect to their overseas operations. NAM opposes these changes because they constitute unsound economic policy. The principal reason U.S. multinational taxpayers have facilities and operations overseas is so they can compete effectively in the global marketplace, not so they can reduce U.S. jobs. Indeed, successful overseas operations usually support many U.S.-based managerial, administrative, research and production jobs.

One example should suffice. The Administration proposes to assign all foreign source royalty income, including royalties related to active operations, to the separate foreign tax credit limitation category for passive income. This will typically give rise to excess foreign tax credits and increase current U.S. tax liability. Existing law already assigns passive royalties to the passive income "basket." Assigning active royalties to the passive income basket would be inappropriate for a number of reasons:

-- It unfairly penalizes companies who choose licensing arrangements, rather than direct sales activities, as a way to enter international markets with U.S.-developed goods and services. The availability of foreign tax credits should not depend upon the manner in which a U.S. taxpayer conducts its foreign operations.

-- The policy underlying creation of the passive income basket does not apply here. A separate basket has been deemed appropriate for categories of income where the income source is easily manipulable, for example, interest on the investment of idle cash. The source of royalty income is not easily manipulable, since it takes its source from the location where the license is used. Hence, once a U.S. company decides to market its product in a given country through a licensing arrangement, the source of the income is pre-determined.

The proposed change in the treatment of royalties should be abandoned.

VI. Selected Revenue-Losing Proposals

Investment Tax Credits. The Administration has proposed two investment tax credits [ITCs]. One is temporary and available only through the end of 1994, and is further limited by being available only for incremental increases in investment over the amount invested during a specified prior base period. The other ITC being proposed is permanent but available only to taxpayers with annual gross receipts not exceeding $5 million.

The temporary incremental ITC is unfair, most likely unworkable, and in any event will be of marginal utility. Despite its announced goal of not rewarding investment that would otherwise take place, it will in fact reward a great deal of investment that is going to take place anyway. The first reason is that, because of this credit's temporary feature, investment that would otherwise take place in 1995 or 1996 might be advanced into the "window" period that ends in December 1994, with little or no net increase in the amount of investment that takes place over the period 1993-1996.

The more fundamental flaw, however, is due to the incremental feature, which will penalize a taxpayer coming off a high point in its capital investment cycle and provide a relative windfall for a taxpayer fortunate enough to be coming off a low point in its investment cycle. Because the principal variable determining whether a taxpayer will be able to qualify for the temporary incremental ITC is where that taxpayer happens to be in its investment cycle, there simply is no way to write the Code provision or the implementing Treasury regulations in a way that will make the availability of this credit anything but arbitrary and capricious. Firms that sacrificed to maintain heavy investment commitments in the face of the recently-ended recession, rather than cut back on such commitments, will be especially disadvantaged for having done so.

Based on the limited information now available about the temporary incremental ITC, its limiting and restrictive rules promise to add an enormous amount of complexity to our already byzantine tax laws, with little payoff in increased capital investment over the long-term. We therefore recommend that the temporary ITC proposal simply be abandoned, and that proposed tax increases totalling three times the static revenue loss associated with the temporary ITC also be dropped. This recommendation is based on the overall three-to-one ratio of tax increases to tax incentives under the President's proposed plan. Our first choice of trade-off would be elimination of the proposed corporate rate increase.

Our major problem with the proposed permanent ITC is that most of our members, including over 60 percent of our small members, have gross receipts in excess of $5 million annually and would be ineligible. NAM continues to believe that the simplest, most effective device for stimulating increased productivity-improving investment is a permanent, non-incremental ITC that is generally available to all taxpayers. If this is not deemed feasible, but there still remains a desire to provide investment incentives that are limited to small business taxpayers, there is no need in that case to clutter up the Code with a new provision. It would be far simpler merely to increase the Code section 179 dollar limit--presently $10,000--on the annual amount of capital investment that a small taxpayer can "expense" rather than depreciate.

Alternative Minimum Tax [AMT] Relief. Any tax bill seeking to promote increased productivity-improving investment must address the corporate AMT issue. It has been estimated that over half of all large manufacturing firms are now in the AMT rather than the regular tax system. These companies are now being penalized for having made large capital outlays in more profitable times. Under the AMT, cash flow that could otherwise be used to fund new jobs or more investment is instead being forwarded to the Treasury Department as, in effect, a prepayment of regular tax liability.

We are encouraged to find that the President's tax proposals include AMT relief. In our view, whatever relief is ultimately crafted should seek to provide significantly better treatment of depreciation under the AMT system. At present, corporate taxpayers in the regular tax system have access to a somewhat accelerated depreciation system that, if not as good as the 1981 Accelerated Cost Recovery System [ACRS], is at least better than what existed prior to 1981. Taxpayers in the corporate AMT system, however, must currently use depreciation calculation much worse than those in effect before 1981. Liberalizing AMT depreciation so that it approximated the pre-1981 system would be a helpful step forward.

VII. Consumption Taxes

NAM believes that income from work, savings and investment is taxed too heavily under the federal tax system as it exists today, and agrees with the President that shifting more of the national tax burden onto consumption is desirable. In our view, however, this would be best achieved not through a BTU or other form of energy tax, but through a general national consumption tax--for example, a VAT--imposed at a uniform rate across the broadest possible base of both goods and services. A general tax on consumption would not penalize U.S.-based firms, while energy taxes would make American firms less competitive. Moreover, the burdens of a general consumption tax would be spread more equitably over the entire U.S. economy, rather than being unfairly concentrated on a single sector that is already suffering disproportionately from large non-tax burdens imposed by government fiat,

such as the rapidly escalating costs of environmental regulation and the severely decreased opportunities for domestic energy exploration and production.

One form of general consumption tax is a value-added tax or VAT. As typically structured, a VAT is a transaction-based tax that is imposed on the sales of goods by businesses at each stage of production and distribution, and on the sales of services as they are rendered. As commonly administered, each taxpayer in the production/distribution chain collects VAT on its sales [i.e., outputs] but takes a credit for VAT paid on its purchases [i.e., inputs] from other businesses, remitting only the difference to the government. End-users, i.e., consumers who do not resell, theoretically bear the full burden of the VAT. It is therefore usually viewed as equivalent in economic impact to a retail sales tax, the principal difference being that it is collected in installments rather than all at once.

A VAT is imposed at the same rate on both domestically-produced and imported goods. Almost invariably, domestically-produced goods that are exported are not subject to VAT. This treatment is fully consistent with GATT rules. It is important to note in this regard that other large tax increases being proposed by the Administration--for example, the increases in corporate tax rates and the rise in employer payroll taxes for Medicare hospital insurance--also have anti-competitive effects identical to those of the BTU or other forms of energy tax: they unilaterally place U.S.-produced goods at a price disadvantage both here and abroad, and there is no GATT-legal way to adjust for this.

It is noteworthy that the U.S. is now the only major industrialized nation that does not employ a VAT type of tax to raise a significant portion of its central government revenue. We strongly recommend that this Committee consider adoption of a general consumption tax such as a VAT as a replacement for many if not all of the anti-competitive income and payroll tax increases contained in the President's economic program.

VIII. Conclusion

In conclusion, Mr. Chairman, we urge the Congress to implement the President's deficit reduction goals to the maximum extent possible by comprehensive, enforceable restraints on spending. To the extent tax increases are required for deficit reduction purposes, we believe that a broad-based general tax on consumption, such as a VAT, will do the least amount of harm to the economy, will avoid damage to our international competitiveness and, if properly adjusted for so as to offset its regressivity, will be the most uniformly fair across all social, regional and economic sectors.

This concludes my prepared testimony, Mr. Chairman. We would be pleased at this time to address any questions you or other members of the Committee might have.

APPENDIX

TABLE 1

COMPARISON OF RELATIVE SIZES OF BUSINESS TAX INCREASES AND BUSINESS TAX INCENTIVES UNDER CLINTON ECONOMIC PROGRAM

Business Tax Incentives

[1993-98; in billions]

28.9	Permanent and temporary investment tax credits
9.6	R&D tax credit
4.1	Enterprise zones
4.1	Low income housing credit
2.9	Exclusion of employer-paid education assistance
1.6	Alternative minimum tax [AMT] depreciation relief
1.4	Real estate changes [passive loss rules, etc.]
1.4	Targeted jobs tax credit
0.7	Targeted capital gains tax reduction
0.6	Youth apprenticeship credit
1.2	Miscellaneous
56.5	

Business Tax Increases

[1993-98; in billions]

42.1	Energy taxes falling directly on business operations
37.9	Individual tax increases falling on business income of sole proprietors, partners and Subchapter S shareholders
30.6	Corporate tax rate increase to 36%
16.1	50% limit on business meals/entertainment deduction
14.6	Employer half of Medicare HI payroll tax increases
8.6	Tax increases on international operations
7.1	Limitation on Puerto Rico tax credit
4.7	Speed-up of estimated corporate tax payments
3.6	Pension plan contribution/benefit limitations
2.0	Penalty increases
1.2	Denial of club dues deduction
1.0	Denial of lobbying expense deduction
0.6	Restriction of deduction for executive compensation
170.1	

APPENDIX

TABLE 2

ENERGY-INTENSITY OF SELECTED* STATE ECONOMIES

[In thousands of BTUs per dollar of gross state product]

State	Energy-Intensity
Louisiana	44.6
Wyoming	34.6
North Dakota	29.0
Texas	28.5
West Virginia	28.5
Alaska	28.4
Montana	26.9
Mississippi	26.0
Oklahoma	24.8
Alabama	24.2
Indiana	23.8
Idaho	23.3
New Mexico	22.4
Arkansas	22.3
Kentucky	22.3
Kansas	21.0
Washington	19.6
South Carolina	19.4
Utah	19.4
South Dakota	19.3
Tennessee	19.2
Ohio	18.2
Iowa	17.5
Oregon	17.5
Nebraska	17.0
Pennsylvania	15.7
U.S. Average	15.7

* States not shown are below the national average and consume less that 15,700 BTUs per dollar of gross state product.

Source: American Petroleum Institute, based on date from the Statistical Abstract of the United States.

APPENDIX

TABLE 3

ENERGY OPERATING RATIOS BY SELECTED INDUSTRIES, 1988.

Industry Groups and Industry	Consumption per Dollar of Value Added (in thousands of BTUs)
Food and Kindred Products	7.6
Tobacco Products	1.4
Textile Mill Products	10.8
Apparel and Other Textile	1.3
Lumber and Wood Products	13.0
Furniture and Fixtures	3.1
Paper and Allied Products	36.7
Paper Mills	64.4
Paperboard Mills	96.3
Printing and Publishing	1.3
Chemicals and Allied Products	22.4
Industrial Inorganic Chemicals, nec	33.1
Plastics Materials and Resins	23.8
Industrial Organic Chemicals, nec	45.7
Nitrogenous Fertilizers	192.1
Petroleum and Coal Products	127.0
Petroleum Refining	143.4
Rubber and Misc. Plastics Products	5.6
Leather and Leather Products	3.3
Stone, Clay and Glass Products	29.5
Cement, Hydraulic	150.7
Primary Metal Industries	45.9
Blast Furnaces and Steel Mills	95.9
Primary Aluminum	65.3
Fabricated Metal Products	4.4
Industrial Machinery and Equipment	2.0
Electronic and Electric Equipment	2.2
Transportation Equipment	2.4
Instruments and Related Products	1.3
Misc. Manufacturing Industries	2.2
All Manufacturing	12.1

Source: U.S. Department of Energy

Mr. KLECZKA. Mr. Hirl.

STATEMENT OF J. ROGER HIRL, CHAIRMAN, EXECUTIVE COMMITTEE, CHEMICAL MANUFACTURERS ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, OCCIDENTAL CHEMICAL CORP., DALLAS, TX

Mr. HIRL. Thank you, Mr. Chairman. I am Roger Hirl, president and CEO of Occidental Chemical Corp. I am here to present the views of the Chemical Manufacturers Association—the CMA—on President Clinton's deficit reduction plan. We have a written statement that I request be included in the committee's record.

Mr. KLECZKA. Without objection, it will be done.

Mr. HIRL. CMA represents more than 90 percent of the productive capacity for chemicals in the United States. Our industry provides 1.1 million high-wage, high-tech jobs for American workers. CMA strongly supports the basic goal of deficit reduction, which must first begin with substantial cuts in Federal spending. We commend the President for his commitment to deficit reduction and encourage additional spending cuts.

The President's program also calls for additional taxes. How you raise revenues is critical to the economic future of our Nation. Tax consumption, and you change behavior; tax manufacturing, and you kill jobs.

Mr. Chairman, CMA urges that you adopt a credit method value added tax, VAT. It is now used by most of our trading partners. The credit method VAT is fair, broad-based and easier to administer than a Btu tax. It is a much better tax and trade policy than current proposals, because the VAT is trade neutral. It could provide increased revenues without creating competitive disadvantage for U.S.-based manufacturers and the jobs they provide to Americans.

Under the GATT and the Canadian Free-Trade Agreement, a nation may make border adjustments of the VAT taxes that impose taxes on imports and provide tax rebates on exports. In contrast, there can be no border adjustment for a new energy tax or income taxes. The energy-intensive chemical industry and the U.S. manufacturing community it serves will be among those most harmed by these new taxes.

In 1992, total chemical exports reached $44 billion and U.S. chemical trade surpluses totaled $122 billion over the last 10 years. Strong U.S. chemical exports enabled us to keep our American workers on the job during the recession, despite falling U.S. demand for chemicals.

However, U.S. chemicals' trade performance is not invulnerable. In the face of intensifying world competition, the chemicals trade surplus has declined from $18.8 billion in 1991 to $16.3 billion in 1992. I note that the fourth quarter of 1992, the trade deficit increased to some $22 billion, the largest quarterly deficit in 2 years.

Even with the feedstock exemption, the administration's proposed Btu tax would cost the U.S. chemical industry about $1.2 billion annually. That is four times the $300 million paid annually in Superfund chemical feedstock taxes.

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Mr. Chairman, preserving the high wage, high-tech American jobs now in our industry should receive a higher priority. These are the high-tech jobs the President wants to preserve and create.

CMA generally opposes energy taxes. Our reasoning is basic: Any tax that raises the cost of U.S. production relative to production abroad damages our ability to compete in both domestic and international markets. That simply is not sound public policy. Our industry uses energy both as a fuel and as raw material for its processes and could be gravely wounded by a unilateral Federal energy tax.

It is a myth that U.S. industrial energy sources are cheap. Many energy cost analyses fail to consider the added environmental costs of consuming energy in the United States, $4.9 billion annually for the chemical industry alone, rising to $10 billion annually by the end of the decade, costs that are not imposed by other major trading partners on their industry.

Most countries in Europe do not impose heavy taxes on industrial energy, as they do on gasoline. After the 1980 enactment of the Superfund chemical feedstock taxes, U.S. chemical exports declined and imports increased sharply. However, after the amendments in 1983 and 1986 to provide border adjustments of Superfund, U.S. chemical exports grew rapidly. The record is unequivocal on the harm to our industry before Congress provided border adjustments on those Superfund taxes.

The proposed Btu tax could be much more damaging to U.S. chemical trade than the Superfund taxes. Any tax on energy sources must include an effective exemption for chemical industry feedstocks. Our international competitiveness depends on it.

The administration's proposal would include an exemption from the proposed tax for nonfuel or feedstock uses. Tailoring an effective tax exemption for more than 70,000 products we manufacture would require great care.

We are also concerned over two other proposals in the administration's program to revise the tax treatment of foreign royalty payments under technology licensing agreements and to increase corporate income tax rates. Our objections are presented in more detail in our formal statement.

In conclusion, let me state again that taxing consumption changes behavior; taxing manufacturing kills jobs. If additional revenues are needed, a credit method value added tax can produce needed revenue without the additional burdens on U.S. international trade that would follow unilateral adoption of an energy tax.

Thank you, Mr. Chairman.

Mr. KLECZKA. Thank you, Mr. Hirl, for your testimony.

[The prepared statement follows:]

STATEMENT OF
THE CHEMICAL MANUFACTURERS ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
MARCH 17, 1993

The Chemical Manufacturers Association (CMA) appreciates this opportunity to present its views on President Clinton's investment and deficit reduction plan.

CMA is a non-profit trade association. Our member companies represent more than 90 percent of the productive capacity for basic industrial chemicals in the United States. The chemical industry is a keystone U.S. manufacturing industry. Our products are vital materials for the rest of U.S. manufacturing and the future of other U.S. manufacturing is vitally important to the U.S. chemical industry. The U.S. chemical industry, despite more than a decade of fundamental restructuring, provides 1.1 million high-wage, high-tech jobs for American workers -- the kind of jobs President Clinton wants to create. Moreover, in 1992 the chemical industry was the largest U.S. exporter, accounting for $1 out of every $10 of U.S. goods exports.

<u>Overview of CMA's Position</u>

President Clinton is to be commended for supporting deficit reduction. CMA is eager to support and work for passage of a budget plan that will help to build America's economic future. Much of the debate about the President's plan concerns the relationship between spending cuts and new taxes. This is an important issue. CMA believes that additional cuts in government spending beyond those proposed by the President should be made. The President's plan, however, calls for new revenues. If, in the end, the Congress calls for new revenues, the important question then is "how can additional revenues best be raised without damage to the economy?" This statement responds to that question.

We believe that <u>"taxing consumption changes behavior, but taxing manufacturing production kills jobs!"</u> Accordingly, if the Congress determines that new revenues are necessary, the best alternative is adoption of the same credit method value-added tax that is already utilized by virtually all of our major competitor nations. By contrast, we believe a Btu tax and other taxes that would disadvantage U.S.-based production that must compete against foreign-based production would not be sound economic policy.

There are multiple advantages to adoption of a value-added tax as an alternative to other new taxes and as the basis for a fundamental restructuring of our tax system that would accommodate to the new realities of a global economy. A value-added tax is a fair tax. It taxes consumption of the nation's resources and adjustments can be made to make it as progressive as other taxes. Second, it can provide a major revenue source. And finally, it is one of the few taxes that is trade neutral. It will not pose a threat to U.S.-based manufacturing and other goods production and will not jeopardize the jobs of American workers.

<u>U.S. Economic Policies Affect International Competitiveness</u>

We are obviously at a critical point in determining our country's economic future. The policies set by this Congress will do much to decide that future. We believe that U.S. economic policies--particularly our tax policies--must recognize that we live and compete in an integrated world economy. Some of our industries--particularly, our manufacturing industries-- must compete in that world economy. Our policy making should recognize that manufactured goods trade is the major means by which countries engage in international economic competition and that U.S. manufacturing bears the brunt of the nation's competition in the international economy.

To illustrate these points, we note that U.S. merchandise exports are now 7.5 percent of GDP and imports are 9.0 percent. But it is also important to recognize that about 80 percent of all of U.S. merchandise trade is in manufactured goods. Moreover, the deterioration of U.S. trade performance during the 1980s was manifested primarily in manufactured goods. Most importantly, trade in goods--not services trade--will remain

the critical interaction of the U.S. economy with the world economy. The point is simply that we need to consider carefully how our domestic economic policies will affect the competitive position of U.S. manufacturing and other U.S. industries that must meet international competition.

U.S. manufacturing's record has not been strong in recent years. Over the last two decades U.S. manufacturing has had to face intensifying international competition. In the process it actually shed some 2.1 million jobs between 1981 and today. Part of this job loss reflects rising productivity in the manufacturing sector--gains essential to improved international competitiveness. But the job losses also reflect a decline in international competitiveness, a decline in which U.S. government policies have played a role. U.S. manufacturing has not regained its earlier strong competitive position. Despite large productivity gains, the manufactures trade deficit in 1992 rose by $20 billion to $86.7 billion. Moreover, every major forecaster projects further increases in U.S. manufactures trade deficits in the years ahead. A manufactures trade deficit of about $100 billion in 1993 seems likely.

The Commerce Department estimates that each billion dollars of U.S. exports supports about 19,000 jobs. Eliminating a manufactures trade deficit of $100 billion by a more competitive U.S. manufacturing sector that expanded its exports and captured a larger share of the U.S. market would create many hundreds of thousands of new manufacturing jobs.

But in the current environment manufacturing job gains do not seem likely. Widening manufactures trade deficits indicate that U.S.-based manufacturing is still not sufficiently competitive in the world economy. Even without new taxes that add to U.S. production costs, we can expect not manufacturing job gains but further manufacturing job losses.

Tax Policy and U.S. Manufacturing

Clearly, a strong, internationally competitive U.S. manufacturing sector is essential to a strong U.S. economy and to growth in U.S. living standards that compares favorably with other industrialized nations. President Clinton has frequently expressed similar views and has emphasized the need to increase investment in America to build its future competitiveness.

Tax and other government policies can have important effects on the costs of U.S. industry. Yet, notwithstanding U.S. manufacturing's existing problems and an already unfavorable competitive outlook, the President's plan has not been structured in a way that recognizes the effects of tax and other U.S. government policies on the ability of U.S.-based manufacturing to compete in U.S. and foreign markets. In the short term it will raise U.S. manufacturing's costs and further damage trade performance. And in the long term it will be a disincentive to the higher levels of investment required to enhance U.S. competitiveness.

Three key provisions of the plan will add significantly to the costs of, and will discourage investment in, U.S.-based manufacturing:

- The proposed Btu tax would add significantly to the costs of manufacturing in the United States--over $5 billion annually to manufacturing as a whole, $1.2 billion of that to chemicals manufacturing costs alone.

- Proposed changes in the tax treatment of income from royalties and licenses will further lower the returns on the R&D that have been instrumental in maintaining the international competitiveness of some of the strongest American manufacturing industries.

- The rise in the corporate income tax rate will lower the rate of return on investment and incentives to invest, particularly investments by manufacturing companies that must face international competition.

We believe it is important that the public recognize that these new taxes cannot logically be seen as tapping "special interests." Instead, each tax will have negative effects on the international competitiveness and the profitability of U.S. companies. These effects would, unequivocally, not be in the best long term interests of members of the U.S. economy--they would hit persons at every income level. This is because each increase in

the costs of U.S. manufacturing firms inevitably must be borne by individual members of the economy at all income levels. Higher costs from energy taxes translate to higher prices to consumers, lower wages to employees, U.S. jobs lost to foreign competitors, and lower profits. In turn, lower profits lead to reduced investment and to lower productivity and lower U.S. living standards than would otherwise be achieved.

CMA believes that, in a highly competitive world economy, it would not make sense to further tax our own U.S.-based manufacturing production. Again, taxing consumption changes behavior, taxing manufacturing production kills jobs! If Congress decides additional tax revenues are required, the interests of all Americans are best served by taxes levied on consumption--not by taxes on U.S.-based manufacturing. A credit invoice method value-added tax (VAT) provides a widely used and accepted means by which the costs of domestic production can be insulated from tax effects. Such a tax, used by virtually every other industrialized nation, is collected at the border on imports, rebated on exports. Accordingly, CMA believes that the Congress should reject a Btu tax that cannot be border adjusted and turn to a credit method value added tax (VAT) as a source of new revenue that may be required, and as a replacement for much of the existing tax system.

From the standpoint of U.S. manufacturing, the negative effects of these three elements of the budget plan--which once enacted are likely to remain in law for an extended period--considerably outweigh the less certain and more ephemeral positive effect on interest rates that is a primary goal of deficit reduction.

The above provides an overview of CMA's reaction to the President's plan. The following offers more specific details concerning individual elements of the plan.

Proposed Btu Tax on Energy Used as Fuel for Production Process Would Seriously Harm U.S. Manufacturing.

CMA opposes energy taxes that fall heavily on the manufacturing process. Our reasoning is basic: Any tax that raises the cost of U.S.-based manufacturing relative to competition abroad damages the ability of U.S.-based manufacturers to compete in both domestic and international markets. Energy intensive industries--including steel, aluminum, pulp and paper, glass, cement, chemicals and agriculture--would be particularly hard-hit. An energy-intensive industry like the chemical industry that uses energy both as fuel and as raw materials for its production processes could be gravely wounded by unilaterally imposed energy taxes.

CMA estimates that, even when applied only to energy used to fuel production processes, the Administration's proposed Btu tax would raise U.S. manufacturing energy costs by over $5 billion yearly. Chemicals is an energy-intensive industry. Its energy costs alone would rise by about $1.2 billion annually with a feedstock exemption, $2.2 billion without such an exemption. It should be noted that the $1.2 billion is four times the $300 million in specific chemical feedstock taxes the industry is already paying annually under Superfund.

The chemical industry produces and sells in a highly competitive market in which margins on any given transaction may be measured in cents per pound. The committee will recall that after the 1980 enactment of the Superfund chemical feedstock taxes, U.S. chemical exports declined and imports increased sharply. Moreover, after amendments in 1983 and in 1986 to provide border adjustments of the Superfund feedstock taxes, U.S. chemical exports grew rapidly and by 1992 the chemical industry was the leading U.S. exporter.

The record is unequivocal on the harm that occurred to our industry before Congress provided border adjustments for Superfund taxes. The proposed Btu tax on the energy used--even if limited to the energy used as fuel or power for our production processes--would be much more destructive to U.S. chemical trade than the Superfund tax. This is both because the Btu tax would be much more costly and because, as a practical matter, the energy tax costs embedded in finished products cannot be adjusted at the border under the General Agreement on Tariffs and Trade (GATT) or the U.S.-Canada Free Trade Agreement (CFTA).

Effective Chemical Feedstocks Exemption Essential for U.S. Chemical Industry.

The U.S. chemical industry is energy intensive. It accounts for almost 7 percent of all U.S. energy consumption. About one-half of that consumption is to power the production process; the other one-half is for feedstocks--the raw materials from which many chemicals are made.

In a highly competitive world economy, any tax on energy sources that does not include an effective, workable exemption for chemical industry feedstocks could end the international competitiveness of the U.S. chemical industry. We understand that the Administration's proposal does include an exemption from the proposed tax for all non-fuel uses, including chemical feedstocks. However, the U.S. chemical industry manufactures more than 70,000 products. Tailoring an effective exemption that would mitigate the harmful effects of the proposed energy tax on U.S. trade in these products will be difficult and will require great care.

Trade Effects of the Btu Tax

The proposed new taxes would also be directly manifested in U.S. trade performance. Energy is an important cost factor at every stage of manufacturing. A Btu tax would raise the costs of manufacturing in the United States. Higher costs of U.S.-based manufacturing will dampen exports and increase imports, with obvious negative effects on U.S. jobs.

The energy intensive chemical industry would be among those most affected. This is significant because the chemical industry has for some years been the epitome of what we all would like U.S. manufacturing to be. Chemicals is a high tech, dynamic, capital and R&D intensive industry, generating about 15 percent of all the nation's registrations of new patents. The U.S. chemical industry employs 1.1 million workers and pays wages to its production line workers that are about 30 percent above the average for U.S. manufacturing.

And it has also been internationally competitive. Chemical industry trade performance has been a particularly important positive factor in the overall U.S. trade picture. For several years chemicals has been the largest U.S. export sector, providing $1 of each $10 of U.S. goods exports. Exports of chemicals reached $44 billion in 1992, more than total U.S. agricultural exports. U.S. chemical trade surpluses in the ten years ending in 1992 totaled $122 billion.

U.S. chemicals trade performance is not invulnerable, however. Recognizing the keystone importance of a chemical industry to a nation's economy and the technology a chemical industry develops and transfers, every developing nation wants its own chemical industry. Many developing countries are building their own production capacity. Some have their own low cost sources of energy. In the face of the resulting intensifying world competition the U.S. chemicals trade surplus declined from $18.8 billion in 1991 to only $16.3 billion in 1992. Further slippage seems likely, even without the added burden of increased energy taxes.

The effects on U.S. trade performance from an increase in U.S. chemical production costs that will result from a Btu tax will, of course, extend far beyond U.S. chemicals trade. The costs of downstream U.S. manufacturers--and their prices--will rise to reflect the increased costs of the chemicals they use and the rise in their own energy costs. This will damage their ability to compete in U.S. and foreign markets.

The Btu Tax and Energy Independence

The Administration projects that the proposed Btu tax will have favorable effects on oil imports, reducing the oil import bill by some $4 billion from the baseline forecast by the year 2000, a 3 percent decline from the level that would result absent a Btu tax. Such a reduction, if achieved, would be welcome but hardly a significant move away from import dependency. Moreover, whether any reduction will actually occur is, at best, highly questionable. One recognized authority, Philip Verleger, Jr. of the Institute for International Economics, believes that the proposed Btu tax may actually increase U.S. dependence on oil imports as well as the dollar value of the imports. This may occur because the tax may exert a greater negative effect on domestic oil production than it does

on total U.S. consumption. And these oil import increases would be in addition to the trade balance deterioration in other products that would stem from the increased costs of U.S. manufacturing industries.

The Btu Tax and the Environment

Environmental benefits are claimed for the Btu tax but the structure and level of the Btu tax rates are such that it will actually engender little or no environmental improvement. There are potentially much more effective and efficient ways of achieving most environmental goals. The Btu tax is primarily a revenue raiser. At the proposed rates, however, it is a cumbersome, expensive tool that, although it hits some industries hard, raises relatively small amounts of total revenue. Much of the revenues would actually come from the tax on gasoline. The Administration estimates the Btu tax will, in effect, raise the price of gasoline about 9 cents per gallon. The implicit tax on gasoline will provide about forty percent of the total revenue of $22.3 billion the Btu tax is projected to raise by 1997.

There is, however, good reason to fear that the proposed Btu tax rates are only the beginning--the thin end of the wedge--and that, over time, the rates would be increased in real terms. This is likely because, at best, the current budget plan makes only a beginning in the reduction of Federal budget deficits and because extending health coverage to all Americans may be seen as requiring additional funds. Once a new bureaucracy is created to administer a Btu tax, there will be a natural tendency to want to use this new revenue source to generate still more funds. These tendencies will be buttressed by pressures from environmentalists who see cuts in energy consumption as an important goal. The result would be an even greater disadvantage to U.S.-based production than would result from a Btu tax at the currently proposed rates.

A Btu Tax and Industrial Efficiency

Much of the support for energy taxes seems to be based on a presumption that energy is cheap in the United States, resulting in its inefficient use. Some argue that energy taxes will, therefore, promote decreased energy consumption and increased energy efficiency with no loss--perhaps even a gain--to U.S. international competitiveness. But this perception stems primarily from the relatively low gasoline taxes in the United States. In fact, contrary to popular belief, U.S. industrial energy sources are not cheap compared to those paid by foreign industry. Gasoline is often much more heavily taxed by foreign governments but they do not impose similar taxes on industrial use of energy. Analyses of energy costs typically do not focus on industrial energy costs. In addition, international comparisons of energy costs inevitably fail to consider the added environmental costs of energy use and consumption in the United States--costs not imposed by our major trading partners.

In fact, U.S. industry cannot use or consume energy as a raw material or fuel without meeting tough, mandated pollution abatement and control standards. The costs of meeting these standards can be very high. For example, the U.S. chemical industry now pays about $4.9 billion annually for pollution abatement and control, and by the end of the decade spending for this purpose will double to almost $10 billion in real terms. Pollution abatement and control measures typically lower productivity and increase energy costs. Therefore, the high cost of meeting these pollution abatement and control standards must be considered as part of U.S. manufacturing's total energy costs.

Concerning the theory that an energy tax will increase energy efficiency, manufacturing firms that must compete in the world economy do not need another tax to make them more competitive. To survive in an ever more competitive world, U.S.-based manufacturing firms must improve efficiency in every aspect of their production, including energy use. The U.S. chemical industry, for example, has improved its overall energy efficiency by 43 percent over the last two decades. Instead of spurring energy efficiency, a Btu tax would drain corporate funds that would otherwise be available for R&D or to invest in new, more efficient plant and equipment. A Btu tax would be an additional handicap on, and disincentive to, investment in U.S.-based manufacturing.

A Btu Tax Would Be A Unilateral U.S. Action

Some also may argue that our competitors, particularly in the European Community (EC), will be imposing energy taxes--perhaps a carbon tax--so that we need not be concerned

about a loss of U.S. competitiveness from a Btu tax. There are several responses to this argument. First, our competition is global, not just in the EC. Indeed, EC chemical production now represents only about one-fourth of the world total. Second, the Europeans have not yet instituted such a tax. Whether they will do so is problematical. Third, when and if they do institute an energy tax, they will not handicap their manufacturing industries. The various proposals that are being examined make it clear that this will be the case. And, recognizing their dependency on trade, there is every reason for them to ensure against harm to their major industries. For example Germany's chemical trade surpluses for 1990 and 1991 summed to $33.7 billion. But just as is true of the United States, in an environment of increasing international competition Germany's chemical trade surplus is already in jeopardy, even without new taxes. In this situation Germany's tax policy is not likely to handicap the trade performance of its chemical industry.

Again, given the disadvantages that a Btu tax would impose on U.S.-based manufacturing, it is important to recognize that there is no valid way under the General Agreement on Tariffs and Trade (GATT) or the Canadian Free Trade Agreement (CFTA) to neutralize the harmful effects of an energy or environmental tax on U.S. trade. In effect, a Btu tax--and the other new taxes on U.S.-based production that are proposed in the President's plan--would penalize U.S. exports in world markets, encourage U.S. imports, and add to a growing U.S. trade deficit.

Proposed Treatment of Royalty Payments under Technology Licensing Agreements Would Penalize U.S.-based Manufacturing.

The U.S. chemical industry has very large investments in production facilities in many foreign countries. The chemical industry is also among the leading developers of new technology and holders of patents both in the United States and worldwide. U.S. parent companies earn significant income from the engineering and technical services they provide to their overseas affiliates. In addition, the income from licensing of their technologies overseas--primarily licensing to affiliates by their U.S. parents--is an important source of the income and international competitiveness of U.S. chemical companies. U.S.-based research costs are very large and must be amortized over sales in global markets if current levels of R&D are to be maintained. Increased taxation of the earnings from licensing is hence a long term threat to the competitiveness of U.S.-based manufacturing.

The proposal to treat all income from royalties and from engineering and technical services earned from the taxpayer's active conduct of trade or business as passive income thus defies logic and lacks any coherent policy rationale. Moreover, the proposal appears destined to achieve precisely the opposite of the stated goals of the Administration's comprehensive economic plan.

Instead of stimulating job creation and providing an environment for long term growth, this proposal more likely would reduce the number of U.S.-based high tech and research jobs, while damaging the profitability of U.S. companies and the long term competitiveness of U.S.-based manufacturing. Instead of improving the domestic base for the export of U.S.-based technology, it is more likely the proposal would increase imports of technology and at the same time would increase exports of associated jobs, growth, and capital. Finally, when royalty payments are made from one related party to another, the proposal arbitrarily differentiates royalties from other types of income, such as dividends and income, received from related parties.

Present Corporate Tax Rates Maintain U.S. International Competitiveness.

The Administration's economic stimulus program should seek to maintain the competitiveness of U.S.-based manufacturers and the American jobs they provide. U.S. tax rate changes will affect manufacturing's international competitiveness. Since 1986, virtually all major trading nations have reduced their own corporate and business tax rates to at or near U.S. levels. Raising U.S. income tax rates under these circumstances would only increase the tax burden of U.S. exports in world markets and the corresponding tax advantage of imported products in the United States. The most important provision for long term economic growth would be to retain the corporate income tax rates enacted in the 1986 Tax Reform Act.

New policies and programs for economic stimulus should not be paid for by increasing these marginal income tax rates.

Revise Alternative Minimum Tax for Effective Economic Stimulus.

CMA commends the Administration for its efforts to improve the corporate alternative minimum tax ("AMT"), especially with respect to the treatment of depreciation. We would suggest that you further revise the AMT to provide additional stimulus to the economy. A majority of large corporations especially capital intensive manufacturers are now in a minimum tax position. The Administration's proposed incremental investment tax credit could be used to reduce the AMT tax burden. After first meeting the restricted qualifications to use the proposed temporary incremental investment tax credit, the credit could offset a maximum of only 25 percent of AMT liability. If the temporary tax credit is to provide a significant incentive to corporate AMT taxpayers, much more reform is needed.

The AMT burden is especially harmful to the competitiveness of U.S. manufacturing when that liability arises from expenditures to meet mandated Congressional environmental standards that do not produce income. Many of our members now pay the AMT because they have made high capital expenditures to meet government mandated pollution standards while their earnings and taxable income are low. Ironically, they and other manufacturers pay the additional AMT tax penalty when they can least afford it. Sound public policy dictates that these taxpayers who are investing to comply with mandated environmental standards should not bear the additional economic burden of the AMT.

Conclusion

It has often been noted that small businesses have been responsible for most of the nation's job creation in recent years. This has provided a rationale for granting them tax incentives. CMA welcomes this attention to the problems of small businesses. However, most small businesses are in various kinds of services industries, ranging from restaurants to computer software and cleaning services. Many of them provide their services to manufacturing firms but very few directly face international competition.

But U.S. manufacturing--much of which is "big business"--does have to face international competition. And in a world economy in which that competition becomes tougher every year, smaller and smaller additions to the cost of production can tilt the competitive balance and the location of manufacturing production.

Popular attitudes often seem to favor "small business" but look less kindly on big business. Yet, for the most part it is the large firms that pay the higher wages, provide their employees costly health, pension, and other benefits, bear the brunt of international competition, and provide the vast majority of U.S. exports. Small businesses play only a small role in international trade. But small businesses in the United States cannot achieve their full potential if U.S. manufacturing fails in international competition. Moreover, the debt and equity instruments of the larger companies are the major holdings of private sector pension funds. Lower corporate profits mean less secure pension funds. Rising corporate profits enhance the ability of retirement funds to meet their obligations to retirees.

The point of this testimony is a simple one. An effective U.S. economic recovery plan that looks to the long term must preserve and enhance--not impair--the competitiveness of U.S.-based manufacturing and the American jobs it provides. Again, taxing consumption changes behavior. But taxing manufacturing production kills jobs! Providing short term economic incentives to some sectors of the economy at the expense of others will not help the economy as a whole. Indeed, paying for these incentives by increasing Federal corporate income tax rates or by imposing a new energy tax or environmental tax would be worse than no action.

If Congress decides additional revenues are required, our trading partners around the world have demonstrated that a credit method value-added tax can produce needed revenue without imposing additional burdens on international trade. A credit method value-added tax is also one of the few tax proposals valid under GATT that could increase U.S. saving and would increase the share of U.S. government costs borne by imported products and manufactures.

CMA does not ask for special favors for U.S. manufacturing. Instead, it asks only that government not disadvantage U.S.-based manufacturing in its ever more difficult struggle to remain competitive in the world economy.

Mr. KLECZKA. We have a pinch hitter today for the Equipment Leasing Corporation of America. It is Edward Dahlka. Mr. Dahlka, welcome.

STATEMENT OF EDWARD A. DAHLKA, JR., DIRECTOR, EQUIPMENT LEASING ASSOCIATION OF AMERICA

Mr. DAHLKA. Thank you, Mr. Chairman and ladies and gentlemen. I am here today as the director for the Equipment Leasing Association of America. We want to address two of President Clinton's tax proposals to stimulate the American economy: first, the reinstatement of the investment tax credit; and two, the modification of the AMT depreciation schedule.

The equipment leasing industry supports the reinstatement of the investment tax credit and believes that a tax credit which has the effect of lowering the cost of capital will act as a stimulus for all types of American companies to acquire new and more productive equipment. Details on how equipment leasing will be treated under the new ITC are not available yet; however, the final legislation enacted by Congress must recognize two important economic facts.

First, equipment leasing companies provide over $120 billion in capital for new equipment each year. This was 32 percent of all durable goods acquired in 1992, according to the U.S. Chamber of Commerce.

More equipment is acquired through leases than acquired through loans. The only way companies can benefit from any ITC equipment acquisitions earned under the President's proposal is to lease the equipment and to have leasing companies utilize whatever ITC was earned on the acquired equipment.

An investment tax credit that fails to accommodate these two realities will fail to help companies that rely on leasing—small, fast growing, new and technology-oriented companies. Leasing expands the capital available to business. It fights the credit crunch.

The unique structure of a lease contrasted with a loan—that is, longer terms, fixed payments and residual balance at lease end-allows the expansion of capital beyond the limits of traditional loans or traditional lenders. Leases expand the amount of capital because they are based not only on the credit decision but on the value of the equipment itself.

Leases provide new money that would not otherwise be available to American business, especially new, small companies. Eight out of ten U.S. companies lease all or some of their equipment. But often companies that lease tend to be focused on productivity. They are companies that are long on ideas, short on capital, and in need of flexibility as they grow and change.

Companies that lease tend to create more jobs and to be the most entrepreneurial and competitive companies. These companies need the benefit of leasing.

In the report of the Treasury Department describing the investment tax credit proposal, a statement is made that leased property would be subject to limitations to prevent shifting of the credit to firms able to claim the credit. Our association takes this to mean that the provisions for leased equipment on new ITC would not

permit leasing to be used to circumvent the targeted or incremental nature of the proposed ITC.

The Equipment Leasing Association agrees with the principle and has studied the matter at some length. Based on the study, the association recommends that the accruing or earning of any credit be based solely on the historical fixed base of an operating company—that is, whether it is owned or leased—and the current level of equipment acquisition at that operating company, again, whether it is owned or leased.

Simply put, leasing companies would not accrue credits based on equipment they lease to end users; only end users would earn ITC.

The intent of the President is to stimulate companies to acquire more, newer, highly productive assets by targeting the accrual of the credit to either small companies or to net new investment. The accrual of new ITC is irrevocably tied to the company using the equipment. This beneficial role that leasing and the lessor can play in providing investment capital, however, can continue by providing that leased equipment, as well as owned equipment, is included in the investment base.

No provision in the tax law should interfere with how business chooses to acquire equipment. Businesses lease for many reasons unique to their own company. Because the intent of the investment tax credit is to incent companies to increase their investment, no additional provisions should be added that limit how companies acquire this equipment.

Modification of the ITC is important to our association. President Clinton's proposal modifies the AMT depreciation schedule and goes a long way toward eliminating a major disincentive to capital investment. In the proposal by the President, which was passed by Congress last year, there are two basic issues that must be addressed to stimulate investment.

The effective date of the change, as proposed currently, is December 31, 1993. Because modifying the AMT depreciation schedule is such a powerful incentive to capital investment, companies will delay that investment until after the effective date. The new effective date should be moved to January 1, 1993, or to the date this committee takes action at the latest.

The chairman of this committee and Secretary Bentsen recognized that American business could delay investment in anticipation of a reinstated ITC, and issued a statement to the effect that the effective date for any ITC would be December 4, 1992. We think the same rationale should apply here for AMT depreciation.

We would also like to address AMT depreciation's rate and recommend a 150 percent declining balance. While the AMT was originally envisioned as applying only to a few companies, the actual structure of AMT has resulted in a much larger number of taxpayers being in AMT, periodically.

The corporate AMT was targeted at large corporations that reported high book profits to their shareholders and reported low taxable income to the Internal Revenue Service. In practice, however, the AMT has primarily and unexpectedly struck at small and medium-sized companies that are only marginally profitable and companies that make large equipment investments in order to improve their productivity and competitiveness.

Extremely capital intensive companies with low profit margins are effectively denied the benefit of accelerated depreciation because they are never able to use these credits.

Mr. Chairman, ladies and gentlemen, we appreciate your attention and consideration to our recommendations. A lukewarm or modest stimulus proposal would be worse than no package at all. Stimulus should be clear, straightforward, easy to use and substantive. As you transform President Clinton's stimulus ideas into actual legislation, please make sure that it makes a difference.

[The prepared statement follows:]

TESTIMONY

OF THE

EQUIPMENT LEASING ASSOCIATION OF AMERICA

Mr. Chairman, Ladies and Gentlemen. This statement is provided by the Equipment Leasing Association of America. Our statement addresses two of President Clinton's tax proposals to stimulate the American economy, the reinstatement of an Investment Tax Credit and Modification of the AMT Depreciation Schedule.

The ITC

The equipment leasing industry supports the reinstatement of an Investment Tax Credit and believes that a tax credit which has the effect of lowering the cost of capital will act as a stimulus for all types of American companies to acquire new, more productive equipment.

Details of how equipment leasing will be treated under the new ITC are not yet available. However, the final legislation enacted by Congress must recognize two important economic facts.

- Equipment leasing companies provide over $120 billion in capital for new equipment every year. This was 32% of all durable goods in 1992 according to the U.S. Commerce Department. More equipment is acquired through leases than through loans!

- The only way many companies can benefit from any ITC their equipment acquisitions earn under the President's proposal, is to lease the equipment and have the leasing company utilize whatever ITC was earned on the acquired equipment.

An investment tax credit that fails to accommodate these two realities will fail to help companies that rely on leasing--small, fast growing, new and technology-oriented companies.

For over forty years, American business has increased its use of leasing--recognizing that the value of equipment comes from its use not its ownership. The Commerce Department forecasts that American business will rely on leasing for $126 billion in equipment in 1993.

Leasing expands the capital available to business--it fights the credit crunch. The unique structure of a lease contrasted with a loan--longer term, fixed payment, and a residual balance at lease end--allows the expansion of capital beyond the limits of traditional loans or traditional lenders. Leases expand the amount of capital because they are based not only on a credit decision, but on the value of the equipment itself. Leases provide new money that would not have been available to American business, especially small or new business, through loans. Eighty percent of U.S. companies lease all or some of their equipment. Companies that lease tend to be focused on productivity. These are companies long on ideas, short on capital, and in need of flexibility as they grow and change. Companies that lease tend to create more jobs and be the most entrepreneurial and competitive. These companies need the benefits of leasing.

Proposal: Leasing and the Proposed ITC

The ITC works--it has a record of stimulating investment whether equipment is owned by the company using the equipment or owned by a lessor. Prior to repeal of the Investment Tax Credit in 1986, all qualified property was eligible for the Investment Tax Credit, whether owned by an end user or owned by a lessor.

Under President Clinton's proposed ITC, certain qualifications for accruing the ITC are established. These qualifications relate to the size of a company and/or any net increase in equipment investment. This adds a new dimension that did not exist under the pre-1986 Tax Act. Consequently, the role of leasing as a provider of capital must be treated differently in the new ITC than it was under the previous ITC.

In the report of the Treasury Department describing the Investment Tax Credit proposal and other parts of President Clinton's economic package, the statement is made that "leased property would be subject to limitations to prevent shifting of the credit to firms able to claim the credit." The association takes this to mean that provisions for leased equipment in the new ITC should not permit leasing to be used to circumvent the targeted or incremental nature of the proposed ITC. The Equipment Leasing Association agrees with that principle and has studied the matter at some length. Based on that study, the association recommends that the accrual (earning) of any credit be based solely on the historical fixed base of an operating company's equipment (whether leased or owned) and the current level of equipment acquisition of that operating company (whether leased or owned).

Simply put, leasing companies would not accrue credits based on equipment they lease to end users, only end users would earn ITC. But they would earn it on all equipment they acquire and use in their business. There would be only one exception. Equipment purchased by lessors to be leased for a short time, virtually a rental, would accrue tax credits for the leasing company under the same provisions other companies accrue and use the ITC.

The intent of the President is to stimulate companies to acquire more, newer, highly productive assets. By targeting the accrual of the credit to either small companies (revenue under $5 million) or to net new investment (investment above the user's base line investment), the accrual of the new ITC is irrevocably tied to the company using the equipment. The beneficial role that leasing and the lessor can play in providing investment capital, however, can continue by providing that leased equipment, as well as owned equipment, is included in the investment base. No provision of the tax law should interfere with how a business chooses to acquire its equipment. Businesses lease for many reasons unique to their own company. Because the intent of the Investment Tax Credit is to incent companies to increase their investment, no additional provisions should be added that limit how a company acquires additional equipment.

A second provision should be included in the law that is consistent with prior law regarding ITC. In many cases, a company that uses leasing to acquire equipment is unable to use the tax credit it accrues. Pre-1986 law provided that a lessor/owner for tax purposes could either use tax credits it accrued on equipment it owned, or pass it to the lessee/user of the equipment. Under the proposed new ITC in which all tax credits would be accrued by the company end using the equipment, the law should provide that the user/lessee of leased equipment has the option to use the tax credit it has accrued or pass it to the lessor of the equipment. This would not create any new tax credits, just ensure that the tax credit is used to stimulate investment. If the user of leased equipment elects to use the credit itself, it receives the economic stimulus to acquire equipment. However, if the lessee is unable to use the credit against its tax liability and get the economic stimulus for acquiring equipment, it can elect to pass the credit back to the lessor/owner of the equipment for the lessor's use. In that case, the economic stimulus for the lessee is reflected in lower lease payments. In either case, the company acquiring and using equipment will receive the economic incentive which President Clinton intends to incent new investment.

Inclusion of the provisions described above related to equipment leasing and the ITC would accomplish two important objectives. It would permit equipment leasing to continue to play its prominent role of providing capital equipment to American business and industry. Neither of these provisions would result in the creation of additional tax credits by leasing rather than owning equipment. Tax credit accrual would be based solely on acquisition by an end user of equipment. Neither provision would allow the shift of investment base or incremental investment between an end user and a leasing company to avoid the stated intentions of the new Investment Tax Credit.

<u>Modification of the AMT</u>

President Clinton's proposal to modify the AMT depreciation schedule goes a long way to eliminate a major disincentive to capital investment. The modification incorporates the basic concepts proposed by you Mr. Chairman and passed by Congress last year. There are two basic issues which must be addressed, however, to stimulate investment.

- The effective date. The President's proposal would install the new AMT Depreciation Schedule for equipment placed in service after December 31, 1993. Because modifying the depreciation schedule is such a powerful incentive to capital investment, companies will delay investment until after the effective date. The effective date should be moved to January 1, 1993 or the date of committee action at the latest. Mr. Chairman, you and Secretary Bentsen recognized that American business would delay investment in anticipation of a reinstated ITC and issued a statement that the effective date would be December 4, 1992. The same rationale should apply here.

- The actual AMT depreciation schedule should be at minimum 150% DB over the recovery period applicable for regular tax purpose.

While the AMT was originally envisioned as applying to only a few companies, the actual structure of the AMT has resulted in a much larger number of taxpayers being in the AMT periodically. The corporate AMT was targeted at large corporations that report high book profits to their shareholders while reporting low taxable income to the Internal Revenue Service. In practice, however, the AMT has primarily and unexpectedly struck at small and medium-sized companies that are only marginally profitable and companies that make large equipment investments in order to improve their productivity and competitiveness.

Extremely capital intensive companies with relatively low profit margins are effectively denied accelerated depreciation permanently because they may never be able to utilize the credits.

<u>Economic Problems with the AMT</u>

- Although the AMT is referred to as a "minimum tax" for an AMT taxpayer, it is <u>always</u> as high or higher than the taxpayer's regular tax.

- The AMT is a disincentive to investment and economic growth because it increases the tax burden of companies who must make large investments in new plant and equipment. The increased taxes reduce the amount of cash available for investment and, therefore, restrict economic growth.

- The AMT penalizes capital intensive firms that have relatively low profit margins for their products. These firms are essentially denied the benefit of accelerated depreciation which is afforded to their non-AMT competitors.

- The AMT credit does not operate effectively in that permanent or long-term AMT payers may never have high enough profits to utilize it as was intended. As a result, they will be permanently denied any benefit of accelerated depreciation.

- Since AMT status is a function of capital spending in relation to profits, those companies who must modernize during or immediately preceding an economic downturn are most penalized.

- The AMT often hits those companies that are least able to pay. Minimum taxpayers are generally capital intensive companies with low profits in relation to capital spending or start-up firms with little income. Increasing their tax burden is usually translated into reduced investment and growth for the firm and reductions in personnel simply because of cash flow problems.

- The AMT encourages mergers. An AMT company combined with a non-AMT company will be able to better utilize accelerated depreciation and other tax benefits. The new consolidated company would pay less tax than each would have paid separately.

- During 1987 and then again in 1990, Congress considered increasing the AMT rate for corporations. Both times, the idea was rejected as being too punitive towards capital investment.

Mr. Chairman, Ladies and Gentlemen, we appreciate your attention and your consideration of our recommendations. A luke warm or modest stimulus package would be worse than no package at all. Stimulus should be clear, straight forward, easy to use, and substantive. As you transform President Clinton's stimulus ideas into actual legislation, please make sure it will make a difference.

Mr. GIBBONS [presiding]. I want to thank all the panel for your contributions to our decisionmaking process here, and I would like to start off by saying that I appreciate all those of you who support the concept of a value added tax.

I want to do it as a replacement tax, not as an add-on tax. I want to replace the payroll tax and the corporate income tax and most of the personal income tax with a value added tax. I want to leave the destination principle in the value added tax, which means imports would be taxed and exports would not; and I want to have a flat rate, and I want to include all goods and services.

I understand there was a difference in your testimony. Some support a credit voucher system of administration, some support a subtraction method of administration. The end result is that they come out the same as far as taxes are concerned. I think the subtraction method is harder to work off kind of special deals, in which I have lost all faith. After 25 years, 26 years on this committee, it looks like all the special deals all wash out in the marketplace. They just add to the complexity of the tax laws.

To the extent we have to do any social engineering, such as taking the regressivity out of a value added tax, I would do that inside legislation, outside of the tax system—just through legislation, probably brought in by our Human Resources Subcommittee on this committee, just a simple give-back to poorer people for what the regressivity actually works out to be.

I know that all of you have some concerns about the size and the impetus of the package that we have here. I have to tell you, honestly, I don't think it is going to do a hell of a lot of good or a hell of a lot of bad either, because I think it really is probably too small to influence the macroeconomics that drive this country.

It is going to add to the complexity of the code; there is no doubt about that; and I feel sorry for everybody who has to wrestle with that monster.

I don't really have any questions for you. I just had those observations I wanted to make at this time.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Listening to the testimony, three of the four panelists basically are opposed to all the tax increases in the plan and indicate that we should have more spending cuts; but also do support the business incentives, which as you know also reduced the Federal revenue.

With that being said, as we talk on the floor of the House, we are debating the budget resolution, which will have the effect of cutting the deficit over 5 years by some $510 billion. Three of the four of you indicated that we need more budget cuts. While our Budget Committee did include in this proposal some additional $63 billion in cuts, I guess my question to the three of you, knowing you are not familiar with the budget resolution, although you have probably read some things about it, what type of recommendations would you have to this committee or to the Congress to actually increase the spending cuts?

It is easy to say, but as you go about doing it, every group that you attempt to cut will come back and indicate that their program is the most important that this government is involved in and,

clearly, you should not cut theirs, but cut the fellow next door or the lady next door.

Let me start with Mr. Huard. What additional cuts would you recommend to this committee and this Congress?

Mr. HUARD. Well, I think you have to start by telling people that they have to cut.

Mr. KLECZKA. Cut what?

Mr. HUARD. I will try to answer your question.

I find it ludicrous that the people who are most intimately familiar with these programs, namely the bureaucrats that administer them and the congressional Members that oversee them, cannot ever find things to cut.

I can tell you that in inflation-adjusted terms, I operate on a budget that is about 65 percent of what it was 10 years ago with about 75 percent of the staff I had 10 years ago, and I have to do more than I had to do 10 years ago.

In the private sector, we cannot print money. When the word comes down from the chief executive you have to cut your departments by 10 percent in staff and 20 percent in budget, we have to find a way to do it. The idea that these departments, HHS or these other departments, can never find a dime to cut, to me, is ludicrous.

And I don't think it is incumbent upon me or the other witnesses here to tell you what to cut. I think it is incumbent on you to figure it out, and the bureaucrats that run these departments to figure it out. There is a way to do it. You have been living off the fact that you can print money for a long time.

Mr. KLECZKA. Thank you for your specificity.

Mr. GIBBONS. Don't you mean borrowed money?

Mr. HUARD. Same thing.

Mr. KLECZKA. Thank you for your insightful and specific recommendations.

Mr. Hirl, it is not the same problem we are facing. It is not the bureaucrats. They are not the ones that come to the office every morning to talk to the congressional office staff. It is the people back home affected by these programs. So it is one thing to blame the bureaucrats, but it is the lobby pressure which comes from constituents who are affected by the various things the Federal Government does.

Mr. Hirl.

Mr. HIRL. I will speak as a representative of an industrial corporation and on behalf of most of the companies who are in this industry. When the chief executive of our company states we must reduce costs, we are given an allocation within our organization. We achieve that because we are directed to do that; and it is in the spirit of everyone sacrifices, that everyone has a special interest, and everyone has a reason not to, but that, in fact, it begins at the top and it pervades the entire industrial enterprise.

It is my opinion that the President has taken that into account in the cut of his staff in the White House, and I am sure there are those amongst those staff who feel it was allocated improperly. But I think that kind of a commitment to reducing spending is what is necessary here. And while everyone has a special interest and

one they cannot do without, it is imperative everyone share in that kind of a sacrifice.

That is the position, I think, that must be adopted.

Mr. KLECZKA. Thank you.

Ms. Gackenbach.

Ms. GACKENBACH. The Chamber shares your concern that if—and we recognize that if we are going to keep advocating spending cuts, we may have to come up with a list. We have recognized that fact.

In an effort to do that, we have started a project through our research affiliate, which is the National Chamber Foundation, that will be going through the budget, account by account, to identify programs that we think are no longer needed and we will have a set of criteria we will be judging things by. That report should be available for you all within the next 3 to 4 weeks, and we will look forward to working with the committee.

Mr. KLECZKA. Fine, thank you. That is the type of input I think lobby groups such as you all represent should have with us, and not just say get the bureaucrats and kick these—I think we need some specifics to give us a hand. Thank you.

Mr. GIBBONS. Mr. Brewster, do you have questions?

Mr. BREWSTER. Thank you, Mr. Chairman. I certainly enjoyed listening to the testimony today. As one who is relatively new on the committee, I have come to the point that I believe the VAT or business transfer tax or something like that has to be implemented to keep us competitive in foreign trade and in other ways. So I would certainly want to move in that direction.

Some other things that I find interesting on the committee, and reviewing where spending goes, I think you are probably aware that 14 percent of this Nation's budget now goes for interest payments; about 35 percent goes to so-called "mandatory others," which is Social Security, et cetera; about 15 percent for Medicare; 20 percent for defense; and currently 15 percent of our entire budget goes to domestic spending for everything—education, agriculture, transportation, HUD, Department of Interior, whatever.

As one who has worked hard on spending cuts and supports the $63 billion additional cuts that we did, I believe we must look at where we can make further cuts. As Jesse James once said, the reason he robbed banks was because that is where the money is. Where the money is in the Nation's budget is in defense or entitlements, Social Security, et cetera.

Should I assume from your comments that these groups would be willing to go on record, then, with further cuts in defense and Social Security and entitlements?

Mr. HUARD. As long as you do both, certainly.

Mr. BREWSTER. As long as you cut both defense and Social Security?

Mr. HUARD. And all the other entitlements. I don't care whether it is beekeeping subsidies or whatever. Once you start holding certain programs harmless—like Social Security is off the table, a couple hundred million dollars—the whole thing falls apart because everybody else is going to say, well, if you are protecting this class of society—and the elderly, frankly, are the wealthiest class of society as a group—why don't we get protection?

So it is a slippery slope, as far as I am concerned. Everybody needs to pay.

Mr. BREWSTER. We have the National Association of Manufacturers on record, then.

What about the U.S. Chamber?

Ms. GACKENBACH. I will get back to you specifically on what we have recommended for entitlements. Spending must be contained, and that has been one of our recommendations, that we must contain entitlement growth.

Mr. BREWSTER. Chemical Manufacturers, as well?

Mr. HIRL. I think the across-the-board perspective we have shared here does do one thing, we perhaps should recognize, and that is priority setting. This Nation needs some priority setting, and where those priorities are are things that we as a manufacturing association, I think the business and industrial community in the United States, would be glad to work with Congress and the President on. But when priorities are set, then everybody shares in the pain.

Mr. BREWSTER. OK. That is a very good answer.

By the way, currently we are borrowing 21 percent of the money spent. That is what the deficit is. With interest and domestic spending roughly equal, the only way you can get there, to true deficit elimination, is with entitlement cuts or entitlement containment.

Thank you.

Mr. GIBBONS. Thank you very much. We will try to look more after your bucks. If you want to call my office, I have a publication I give out for free.

Mr. HUARD. I don't know which of the four supported the business tax, but I want to be on record to show it wasn't me.

Mr. GIBBONS. All right, let's have the American Waterways Operators, Joseph Farrell, president; the Massachusetts Port Authority, the American Great Lakes Ports, and the Ports of Tacoma and Seattle, Anne Aylward, maritime director, accompanied by Davis Helberg, executive director, Seaway Port Authority of Duluth; National Waterways Conference, Inc., Harry Cook, president; and the National Grain and Feed Association, Stephen Lucas, director, Logistics and Operations, Louis Dreyfus Corp.

Let me see, I guess I am just going to go down this—I could start on your right and just go across, or start on the left and go across, or I can start by the list. Which way would you all prefer?

Ms. AYLWARD. Go with the list.

Mr. GIBBONS. Go with the list.

Mr. Farrell.

STATEMENT OF JOSEPH A. FARRELL, PRESIDENT, AMERICAN WATERWAYS OPERATORS

Mr. FARRELL. Thank you, Mr. Chairman. I am Joe Farrell, president of the American Waterways Operators, which is the national trade association for the barge and towing industry, both coastal and inland. I would ask that our formal testimony be entered in the record.

Mr. GIBBONS. Yes, sir. Let me assure all the witnesses your formal testimony will be in the record, as if delivered, even if you choose to summarize it.

Mr. FARRELL. Mr. Chairman, I will be brief. We are gratified with the opportunity to shed some light today on the impact of the administration's economic package.

I refer to the 525 percent proposed increase in the inland waterways diesel fuel tax. And I want to make sure I distinguish that from the across-the-board proposal for a Btu-type tax. The Btu tax would add 8 to 10 cents a gallon to diesel fuel. On top of that, this proposal would increase our taxes for fuel by 525 percent. And I think virtually anybody would quickly agree that no individual or operation should stand a 100 percent tax increase, never mind a 525 percent.

In thinking about it, it seems to us rather clear that this was done in haste. The administration threw together a very large program in a very short period of time. My crude arithmetic suggests we constitute sixteen-one hundredths of 1 percent of the whole package, so I can understand why not much attention was paid to it.

It was a mistake, a well-intentioned mistake, it seems. President Clinton apparently agrees with that. He was interviewed by a reporter from CBS News on March 1, and when he was asked about this, he said, I think we have to go back and look at that again. We had no intention to quintuple the tax.

In fact, it seems to me that there is some perversity in this, if I may put it that way. The President, in his campaign and subsequent to his inauguration, has talked about spurring the U.S. economy with investments in infrastructure, in people and in high-technology goods.

The barge and towing industry has more on-board jobs on our vessels than any other component of the U.S. maritime fleet. We have more vessels by far. We are the major component of maritime infrastructures. Our industry is also the most productive mode of transportation. We carry approximately 15 percent of all the Nation's freight every year for only 2 percent of the transportation bill.

So, in sum, I would suggest that rather than a proposal that would literally tax the industry to death, would destroy the inland barge and towing industry, that the administration should be investing in this part of American infrastructure to enhance further the productivity of the industry and to help spur economic growth and development.

All through the history of this republic, the Federal Government has chosen to invest in various transportation modes in order to spur development. You can go all the way back to the early 19th century with the Erie Canal, and on to the land grants for the railroads, and President Eisenhower's Interstate Highways System, and the work that has been done from about the 1930s on the great locks and dams on America's treasure, and the inland rivers. In every case, these were not subsidies. We need to understand that that was an investment in economic growth and, in fact, it worked providing the cornucopia of benefits for American citizens all across this country.

Thank you for the opportunity to present our views to you today, Mr. Chairman.

Mr. GIBBONS. All right, Mr. Farrell.

[The prepared statement follows:]

Testimony of Joseph A. Farrell
President
American Waterways Operators

Chairman Rostenkowski, Members of the Committee, my name is Joe Farrell, and I am President of the American Waterways Operators, the national trade association representing the inland coastal barge and towing industry and the shipyards which build and repair these vessels. Given the magnitude and multitude of budget considerations which this committee must address, I would like to express my appreciation to you, Mr. Chairman, for allowing the issue of the proposed increase in the inland waterways fuel tax to be given a full airing before the committee.

Like many Americans, we were encouraged by candidate and now President Clinton's call for change, emphasizing job security, economic growth, and fiscal responsibility. We were also particularly pleased by his recognition that infrastructure plays a critical role in establishing the foundation for a sustained economic expansion from which all citizens benefit. Buried in the details of the Administration's economic program and scored as a spending cut, however, is a shocking 525 percent increase in the diesel fuel tax levied on commercial navigation interests using the inland waterways system. Because this fuel tax increase will in fact encourage only disinvestment in waterways infrastructure, we submit that it is grossly inconsistent with the stated aims of the Administration's economic plan and should therefore be abandoned. Fortunately, the President, when questioned about the issue in a March 1 CBS news interview, stated that the inland waterways tax issue "needs to be reexamined." Unfortunately, the proposal is still buried in the Budget Resolution which will be voted on this week in both the House and Senate.

In his transmittal letter to Congress, the President described his "vision of change" as including investment in people, reward for hard work, fairness, and recognizing that our families and communities are the cornerstone of America's strength. That vision was long ago seen and followed by the founders of this industry -- some of whose families still ply the waters of our great inland waterways network. Most of the companies in our industry are what is characterized as "small business."

To these men and women who manage and operate America's barge and towing industry, the inclusion of an increase on the inland waterways transportation sector forces us to conclude that the Administration makes this proposal without having had the opportunity to gauge the consequences. This proposed tax, if enacted, would capture approximately 25 percent of the industry's annual revenues. No industry in America could survive such a blow.

In order to measure and appreciate the impact such a tax increase would engender, it is first necessary to understand the role waterborne transportation plays in the nation's economic infrastructure. For less than 2 percent of the nation's transportation costs, we transport 15 percent of the nation's freight, over half of all export grain, 20 percent of all coal, over 30 percent of the nation's petroleum products, and 20 percent of the logs and woodchips destined for overseas markets -- and do so in the most economic, fuel efficient, and environmentally sound method offered by any of the competing bulk commodity transporters. This industry is America's most productive mode of transportation. Our vessels deliver agricultural fertilizer to farmers; grain to food producers and export ports; building materials to construction sites; iron and steel to factories; coal to electric generating plants; and home heating oil and gasoline to millions of Americans. The cargoes go to all sectors of the American economy, and thus play a significant role in enhancing U.S. competitiveness, both domestically and in the expanding international marketplace.

Before elaborating the harmful effects of the proposed tax, however, it is important to invalidate the Office of Management and Budget's (OMB) oft-told myth that the barge and towing industry is the most subsidized transportation mode, is the sole beneficiary of federal expenditures on the rivers, and is therefore an appropriate target for such a tax gouge. OMB apparently forgets that all river construction projects must meet federal

requirements that the benefits of each project surpass by a large margin the construction costs, before work can begin. This rigorous test is required by federal law. And, the barge industry is the only transportation mode which must pass such a test. OMB apparently forgets that all these federal expenditures on transportation ... land grants to the railroads, subsidies to build and maintain the interstate highway network, inland river locks and dams ... are investments to foster economic development. Not one has failed to provide a cornucopia of benefits to American citizens.

Specific to the river valleys, the expansion of communities and businesses could not have occurred without federal spending to maintain the waterways. Consider also that maintenance of the channels and operation of the network of dams on the rivers are essential to flood control. Scores of communities along the Ohio River get their water supply from the river. Recreational and environmental interests ... boaters, fishermen, campers, hunters, the preservation of sanctuaries and habitats for a great variety of fish, mammals, and birds ... benefit enormously from the work of the U.S. Army Crops of Engineers.

Although clearly **not** the sole beneficiary of the system, the barge and towing industry is the lone waterways user-investor -- diesel fuel taxes paid **only** by the barge and towing industry into the Inland Waterways Trust Fund already finance 50 percent of the construction and rehabilitation expenditures each year. Currently, this dedicated tax is 17 cents/gallon, with mandated additional increases set at 19 and 20 cents, respectively, in 1994 and 1995. Given these facts, it is fiction that the barge industry is the beneficiary of disproportionate federal largesse.

Under the President's proposal, which would take effect in FY 1994, that 19 cents would be raised by $1.00 per gallon to $1.19 over four years, be earmarked not for construction but for overhead costs, and is estimated to cost the industry $820 million during the period. The immediate implication of such a tax is not speculation. The average towboat that uses 5,000 gallons of fuel per day would see its fuel costs, which account for one-third of its operating overhead, skyrocket by $5,000 per day. The cost of a typical 14-day trip carrying grain, corn, or soybeans from Minneapolis to New Orleans would increase by $70,000. One needs to understand, in order to grasp the true consequences of this proposed tax, that this industry's vessels make 125,000 trips in a given year. Considering these daily operational cost impacts and the fact that the revenues generated by this industry are far less than the contribution level the Administration is asking us to make, you can no doubt appreciate our opposition to the proposal.

Beyond what the media would no doubt dub our special interest pleading, we believe it is most important that you also consider the macro-economic impact this proposal would have on the many commodity sectors which rely on us as both a transporter of their products and also as an insurer of the benefits of competitive pricing for bulk commodity transport.

As referenced earlier, the barge and towing industry moves over half of all grain shipments bound for export. Under the Administration's plan, the fuel cost per ton for grain shipments from St. Paul, Minnesota; Quincy and Pekin, Illinois; and Dubuque, Iowa; to the Gulf would increase by *130 percent*, *126 percent*, and *125 percent*, respectively. Coal operators would likewise be hit (over and above the BTU energy tax proposal). Specifically, the fuel cost per ton for barge coal movements from the Big Sandy, Kentucky/West Virginia; to Pittsburgh, Pennsylvania; Cincinnati, Ohio; and the Gulf, would increase *137 percent*, *136 percent*, and *132 percent*, respectively. Shipment fuel costs from the Kanawha River, West Virginia, to the Gulf would likewise increase *131 percent*.

As stated earlier, the foundation of President Clinton's vision of America is built on investment in our nation's infrastructure, technologies, and people, so that this nation will be positioned to compete in global markets. Our ability to compete globally goes to the heart of creating and retaining high-paid jobs in the future. Given the magnitude of the

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projected cost increases cited above, it is clear that exports of grain and coal would be severely impacted, which obviously runs counter to the President's stated goals.

During the campaign, President Clinton also appropriately noted investment in transportation systems that other nations have made have better positioned them for international competition. For example, Japan invests 23 times as much as the United States in infrastructure; and in Germany, 15 times as much. Part of the Administration's strategy is to follow this example. The impacts of the proposed fuel tax increase are clearly inconsistent with their stated objective.

These referenced samplings of fuel cost increases assume that barge operators will be able to pass along these costs and will not be forced out of business; for many small and medium sized operators, which constitute the core of this industry, this unfortunately is not a realistic assumption. Moreover, to the extent that price competition, barge to barge, or barge to rail, is diminished by this proposal, rates for commodity shippers will no doubt increase further and other negative non-pricing factors will also go up as well. For example, Minnesota's Department of Transportation found that if waterways traffic in the state were shifted to rail, fuel use would increase by *331 percent*, emissions by *470 percent*, and probable accidents by *290 percent*. If the traffic diversion went to trucks, these same negative impacts would increase *826 percent*, *705 percent*, and *5,967 percent*, respectively. Moreover, for every 16 barge tow -- an average sized tow on the Mississippi -- it would require 1000 semi-truck loads to haul the equivalent cargo.

In *A Vision of Change for America*, President Clinton rightly underscored the need to provide funds to maintain and enhance America's infrastructure to spur economic growth and prosperity. The barge and towing industry, which provides more on board jobs than any other in the maritime sector, is the marine component of this infrastructure. One would thus expect that rather than quintupling the inland fuel tax on top of leveling a BTU tax, the federal government should be boosting this transportation mode by advocating programs which lower the costs for the industry.

Mr. Chairman, we urge you to reject this proposed diesel fuel tax increase and enable the barge and towing industry to continue to support and enhance our domestic and export economies.

Mr. GIBBONS. Ms. Aylward.

STATEMENTS OF ANNE D. AYLWARD, MARITIME DIRECTOR, MASSACHUSETTS PORT AUTHORITY, DAVIS HELBERG, EXECUTIVE DIRECTOR, SEAWAY PORT AUTHORITY OF DULUTH, MN, AND JOHN J. TERPSTRA, EXECUTIVE DIRECTOR, PORT OF TACOMA, WA, ALL ON BEHALF OF THE MASSACHUSETTS PORT AUTHORITY, AMERICAN GREAT LAKE PORTS; AND PORTS OF TACOMA AND SEATTLE

Ms. AYLWARD. I am the maritime director at the Massachusetts Port Authority and immediate past chairman of the North Atlantic Port Conference and the American Association of Port Authorities. We are pleased to have an opportunity to testify today in support of the intent of President Clinton's proposals for public investment and deficit reduction as they apply to the ports of the United States in general and to the ports which we represent directly in particular.

As you know, Mr. Gibbons, the deep-draft ports of our country handle 95 percent of the Nation's international trade, which comes to nearly 1 million tons of cargo a year worth nearly $500 billion. Our commercial port activities generate 1.5 million jobs for American workers and return more than $19 billion in taxes to our local, and State and Federal governments.

But unlike many countries in the world, the United States does not have a Federal port system. The responsibility for development of the ports of our country is the responsibility of local, county and State governments, and since the end of the Second World War, the public, local, State port authorities in this country have invested more than $10 billion to develop modern port facilities to meet the needs of our shippers and keep pace with technology changes.

We are mandated by law to serve public purposes, primarily the facilitation of waterborne commerce and the generation of local and regional economic growth. As public agencies, we share the public interest in serving our country's economic, international trade, and national security objectives. We are also the Nation's link to world markets.

As public agencies, our ports are well aware of the difficult fiscal climate in which governmental entities must operate. We are prepared to play our part in the difficult tasks of reducing the Federal deficit and regenerating the national economy. We are prepared to continue to invest local and State dollars in our national infrastructure.

Specifically, we support the President's proposal to authorize expenditure by Customs of up to $5 million annually for increased enforcement of the Harbor maintenance tax. However, we strongly oppose any further increase in trade taxes beyond that in the current proposal.

We remember clearly the closing days of the 101st Congress when, in the name of budget reconciliation, new taxes were levied and old taxes increased with little, if any, evaluation of the overall impact on the international competitiveness of U.S. industry. The effect of those new and increased taxes was less competitive U.S. export products and higher costs to consumers. We need to be careful not to make that mistake again.

We need to be sure that we know the impact on our trade and competitiveness before requiring additional trade taxes. The GAO, in its study of Federal assessments on the maritime industry, which was released last week, identified 12 Federal agencies which levy a total of 117 diverse assessments for total collections of $11.9 million in fiscal 1991; 92 percent of these collections go directly back to the General Fund of the Treasury. Only 8 percent reimburse the agency actually providing a service or generate a port-related trust fund.

Now, if you will forgive me, that doesn't sound to me like user fees. The GAO study—for those of you who have not read it, is it just a tremendous addition to—to the record it is the first time that we have seen the various taxes and user fees collected in one place; and I think it is very important that we use it as a tool in assessing any future impacts of Federal taxes.

We are particularly concerned about the harbor maintenance tax and would take this opportunity to reiterate the position of the American Association of Port Authorities on this tax. Our member ports strongly oppose any further increase in the tax, seek to ensure that the tax is used only for its intended purpose, to maintain our harbors, and that it is set at a level needed to maintain our deep-draft navigation system. We oppose the accumulation of any surplus or use of the fund for deficit reduction purposes.

As you know, the tax was established in 1986, but tripled by the 1990 Omnibus Reconciliation Act. There is little evidence that the current level of the tax is warranted by dredging expenses. Although the report detailing the receipts and expenditures from the fund required by section 330 of the Water Resources Act of 1992 is not yet available, it is estimated that the Harbor Maintenance Tax Fund currently has a surplus in excess of $100 million.

The northern tier ports of our country have been most adversely impacted by this tax because it resulted in diversion of cargo to Canadian ports, and my colleagues will speak specifically to that issue in a moment.

But, in summary, trade taxes are regressive. Taxes cannot be collected on commodities not shipped internationally because they have been priced out of foreign markets or are escaping U.S. taxes by fleeing across the border to Canadian ports. From a national perspective, the revenue is lost to the U.S. Treasury; cargo which could more efficiently move by water is, instead, imposing a further load on our already overburdened highway and bridge systems; and worst of all, the tax is a disincentive to export.

We look forward to working with you as you face the difficult task of reducing the Federal deficit. Our ports are an important part of our national infrastructure; we need them to regenerate economic growth. Thank you very much for the opportunity to testify.

My colleagues from the Ports of Duluth and Tacoma will expand on the issues that I have raised.

Mr. GIBBONS. Fine. Why don't we go to them next then.

Mr. HELBERG. Thank you, Mr. Chairman. I am Davis Helberg, executive director of the Seaway Port Authority of Duluth, Minnesota. I am past president of the International Association of

Great Lakes Ports and presently serve as U.S. vice chairman of the American Association of Port Authorities.

This past fall I was a firsthand witness to the demise of a steamship service caused in large measure by the sheer weight of maritime trade taxation, in this case the harbor maintenance tax. The Incan Superior was, or is a rail car ferry that, starting in 1974, made about 160 trips a year carrying forest and agricultural products between Thunder Bay, Ontario, and the Superior, Wisconsin, side of our Port of Duluth.

This little ship had a loaded draft of 17 feet. Our harbor is maintained at a depth of 27 feet. But even though maintenance dredging was a service that the Incan neither needed nor desired, she was required to pay, like everyone else, the harbor maintenance tax.

When first imposed beginning in 1987, this so-called user fee cost the Incan's owners about $65,000; 4 years later in 1991 the tax rocketed up to some $200,000.

We tried hard in the past couple of years to get a waiver or some other kind of exemption through the Congress, because the owners said that tax was threatening to kill the business. We were unable to advance any special legislation, however, because we were told there were so many inequities caused by this tax along the border States that Congress would simply be swamped with "me-too" amendments.

Well, the service was terminated this past November, Mr. Chairman, the Incan Superior sailed out of the Great Lakes, and she is now in an all-Canadian run on the West Coast. The Incan's cargo, however, is still moving. It has added 18-wheel trucks to a scenic highway that is already crowded with cars and campers and recreational vehicles between Duluth, Minn., and Thunder Bay, and some is being carried by a circuitous Canadian-owned railroad route.

On the Great Lakes, we are keenly aware of the fragility of our trade. We can lose cargo to a modal shift, as in the case of the Incan, or we can lose cargo outright in the vigorous competition between United States and Canadian shippers in, say, the export grain trade.

Our written statement makes reference to markets being won or lost on a "a few cents a ton."

I have seen grain cargoes, Mr. Chairman, won or lost on a cent per bushel. The geography of the Great Lakes puts us in a cheek-by-jowl position with our Canadian neighbors, whether it is Duluth and Thunder Bay, Detroit and Windsor, Cleveland and Toledo looking over at Toronto and Hamilton, or the ports of Chicago and Milwaukee and Indiana, all reliant on this binational seaway. We are in the front lines of our Nation's competition for overseas market with the Canadians. The harbor maintenance tax frankly has hurt us. So has the customs tonnage tax, which was quadrupled in 1990 and was promised to be a temporary measure.

In short we have two requests. Roll back the harbor maintenance tax to the 0.04 percent. Number two, adopt a policy whereby no new or increased maritime trade taxes are promulgated without first evaluating the impact on U.S. commerce including, Mr. Chairman, the understanding and recognition that a shift of cargos from

the waterways to other modes of transportation will require more energy, will cause greater negative impact on the environment, and will create more social disruption and urban traffic stress.

I specifically call your attention to page 6 of the American Waterways Operators testimony which quotes a Minnesota Department of Transportation study regarding this matter. Thank you very much for this opportunity.

Mr. GIBBONS. Thank you.

Mr. TERPSTRA. Mr. Chairman, I am John Terpstra, the executive director of the Port of Tacoma in the State of Washington. I certainly support the testimony already given by the directors of the Port of Boston and the Port of Duluth. I would like to describe, though, an additional burden that the ports of Tacoma and Seattle in the Puget Sound must overcome along with the diversion issue created by the harbor maintenance tax.

The Puget Sound ports of Seattle and Tacoma, two of our Nation's largest ports, are naturally deep, low maintenance ports that need very little of this maintenance funding, yet we serve the entire United States as national gateway ports. Together the ports of Tacoma and Seattle average only about $100,000 annually in harbor maintenance dredging, yet Customs collects about $50 million in harbor maintenance taxes from those cargoes that pass through our ports.

This discrepancy accentuates the diversion burden on the Puget Sound ports and other ports that do not require large amounts of maintenance by providing a financial advantage to other competing U.S. ports that require high volumes of expensive annual dredging. It is because of this that we certainly support reasonableness in this type of tax if not potentially its elimination someday because of that equal playing field that we desire.

Thank you very much for allowing me to testify.

[The prepared statement follows:]

TESTIMONY OF

THE MASSACHUSETTS PORT AUTHORITY

THE AMERICAN GREAT LAKES PORTS

AND THE PORTS OF TACOMA AND SEATTLE

Introduction

We are pleased to have an opportunity to testify today in support of President Clinton's proposals for public investment and deficit reduction as they apply to the ports of the United States in general and to the ports we directly represent in particular. Ports will benefit from many of the proposals, including full funding of the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) and funding for Economic Development Administration grants.

The deep draft commercial ports of our country handle 95 percent of the nation's international trade -- nearly one million tons of cargo a year worth nearly 500 billion dollars. Commercial port activities generate 1.5 million jobs for American workers and return more than 19 billion dollars in taxes to our local, state and federal governments.

Historically, the planning, development, management, and maintenance of our public ports have been the responsibility of local, county and state governments. Since the end of World War II, our public port authorities have invested more than ten billion dollars to develop modern marine facilities to meet the needs of American shippers and keep pace with rapidly changing shipping technology.

We are public entities mandated by law to serve public purposes -- primarily facilitation of waterborne commerce and the generation of local and regional economic growth. As public agencies, we share the public interest in serving our country's economic, international trade and national security objectives. Public ports are a vital conduit linking the United States to world markets. We serve broad hinterlands, connecting farmers, manufacturers and suppliers, often thousands of miles inland, to markets thousands of miles from our shores, and bringing low cost goods to American consumers.

As public agencies, our ports are well aware of the difficult fiscal climate in which government -- federal, state, and local -- must operate. We are prepared to play our part in the difficult task of reducing the federal deficit and regenerating the national economy. We are prepared to continue to invest local and state dollars in our national infrastructure.

Specifically, we support the President's proposal to authorize expenditure by Customs of up to five million dollars annually for increased enforcement of the Harbor Maintenance Tax. However, we strongly oppose any further increase in trade taxes.

We remember clearly the closing days of the 101st Congress. In the name of budget reconciliation, new taxes were levied and old taxes increased with little, if any, evaluation of the overall impact on the international competitiveness of U.S. industry. A myriad of new or increased taxes directly affecting the maritime industry were levied, including the Harbor Maintenance Tax, vessel tonnage tax, direct and indirect Coast Guard user fees, Customs user fees, St. Lawrence Seaway tolls, and the APHIS vessel inspection fee, to name a few.

The effect of these new and increased taxes was less competitive U.S. export products and higher costs to consumers. We don't want to make that mistake again. Let's be sure we know the impact on our trading competitiveness before requiring any additional trade taxes. The GAO in its study of Federal Assessments on the Maritime Industry, released last week, identified twelve federal agencies levying a total of 117 diverse assessments for total collections of 11.9 billion dollars in fiscal year 1991. Ninety-two percent of these collections go directly to the General Fund of the U.S. Treasury. Only eight percent reimburse the agency providing the service or generate a port related trust fund. So much for "user" fees!

At a time in which global competitiveness is key to our nation's future, these increased trade taxes are a disincentive to export. Exports are increasingly necessary to the health of America's economy, especially as we try to fuel an economic recovery. One out of six U.S. manufacturing jobs can be linked to exports, and more than one-third of major U.S. grain crops are exported. Export growth is essential to our future international competitiveness.

For bulk commodities in close-margin international markets, such as grain and coal, just a few cents a ton can determine the commodity's competitive position in the marketplace.

These taxes have also increased the cost of using U.S. ports, encouraging the diversion of cargoes from U.S. to foreign ports. Together, these effects mean a decline in U.S. competitiveness, income, and jobs.

We are particularly concerned about the Harbor Maintenance Tax and would take this opportunity to reiterate the position of the American Association of Port Authorities on this tax. The U.S. member ports of AAPA strongly oppose any further increase in the Harbor Maintenance Tax and seek to ensure that the tax is used only for its intended purpose and is set at the level needed maintain our deep draft navigation system. We oppose the accumulation of any surplus or use of the fund for deficit reduction purposes.

Background on the Harbor Maintenance Tax

The Harbor Maintenance Tax was established in 1986 (P.L. 99-662) to offset the Corps of Engineers' cost for maintaining America's harbors and ports. Previously, these activities were paid entirely from general tax revenue, but, under the 1986 statute, the Corps was authorized to recover up to 40 percent of its operations and maintenance costs from Harbor Maintenance Trust Fund revenues.

The 1986 law authorized the U.S. Customs Service to begin collecting a .04 percent tax on the value of waterborne commerce and passenger fares moved through U.S. ports. It was adopted with the express understanding that it would not be raised further. To quote from the Senate Finance Committee report:

> "In light of its concern that rate increases could have adverse economic consequences, the Committee does not intend to increase the rates of port user charges above the levels established in the Committee amendment. The Committee believes that higher rates would unduly increase the costs to consumers of imported goods, disadvantage the competitiveness of American products and commodities in the international marketplace, and likely result in economic disruption of the port industry."

Despite this intent, unexpectedly and without consultation or prior study of its impact on trade, the Omnibus Reconciliation Act of 1990 tripled the fee to .125 percent ad valorem. The only justification for the change was to raise revenues to recover 100 percent of the Corps' authorized operations and maintenance costs.

There is little evidence that the current level of the tax is warranted by the amount of port dredging expenses. Although the report detailing the receipts and expenditures from the Fund required by Section 330 of the Water Resources Act of 1992 (due on March 1st) is not yet available, it is estimated that the Harbor Maintenance Tax Fund currently has a surplus in excess of one hundred million dollars.

Cargo Diversion

All U.S. coastal ranges have been adversely impacted by additional trade taxes; however, the Harbor Maintenance Tax is a particular concern for U.S. seaports bordering Canada. The diversion of cargo to Canadian ports is a very real problem faced by the northern tier U.S. ports, from the Pacific Northwest, across the Great Lakes to the North Atlantic. The U.S. Maritime Administration's most recent study of cargo diversion reported that more than 11 billion dollars in U.S. trade moved through Canadian ports in 1989.

American ports in the North Pacific, Great Lakes, and North Atlantic ranges engage in intense, direct competition for cargo with Canadian ports. It is important to understand that we welcome the opportunity to compete with our Canadian neighbors in an open market. However, the multitude of federal tax and fee increases has distorted the historical balance of cargo flows. A few examples will serve to highlight the distortions created by the increase in this tax:

Cargo moving on an average container ship calling at a U.S. port generates about $75,000 in harbor maintenance taxes. Shippers can avoid these costs entirely by moving their freight through Canadian ports where no such federal tax is collected.

The Puget Sound ports of Seattle and Tacoma, two of our nation's largest ports, are naturally deep, low maintenance ports that handle a high volume of high-value cargo. Together, these ports average only about $100,000 in harbor maintenance dredging expenditure annually, yet Customs collects about $50 million in harbor maintenance taxes. In other words, the shippers who use these major Puget Sound ports pay a dollar for each penny of benefit in harbor maintenance. This discrepancy should be of concern beyond Puget Sound -- 73 percent of all cargo moving through these ports has an origin or destination east of the Rockies.

The Harbor Maintenance Tax increase has had a similarly negative impact on the North Atlantic. While .125 percent sounds like a small amount, its impact on New England's high value cargo has been dramatic. Multinational high technology companies have documented an increase of $200 to $400 per container. By comparison, total container handling charges at the Port of Boston average less than $300. The Port of Boston handles eight billion dollars worth of cargo annually. The tripled harbor maintenance tax assesses ten million dollars annually against this cargo. However, the port's natural deep water does not require frequent maintenance dredging. In the past five years, the Corps records no expenditure of funds for maintenance dredging in Boston Harbor. In light of this, it is not surprising that New England shippers have been at the forefront of the fight to rollback the Harbor Maintenance Tax.

The impact of the tax increases on the U.S. Ports of the Great Lakes with their direct geographic proximity to the Canadian Great Lakes Ports has also been significant. Perhaps the most dramatic is the story of the Incan Superior. The Incan, a roll on-roll off railcar ferry, made 160 trips a year between Thunder Bay, Ontario and Duluth, Minnesota-Superior, Wisconsin. She carried forest and agricultural products between the two ports. The alternative was a circuitous loop on Highway 61 around Lake Superior's north shore. During the summer season this highly traveled road already has a serious conflict between auto and truck traffic. There as little doubt as to the economic and environmental benefits of the Incan Superior's service. However, with the tripling of the Harbor Maintenance Tax, the Incan's owners were faced with a tax which increased overnight from $68,000 per year to $220,000 per year. It is interesting to note that while this tax might, in theory, help to maintain Duluth's channel depth of 27 feet, the Incan Superior draws only 17 feet. As you might guess, this story does not have a happy ending. With the huge tax increase, the Incan service could not compete with overland transportation and was terminated. The vessel is now operating on the Canadian west coast and freight between Duluth and Thunder Bay has now been added to the congestion of Highway 61.

In each case, since cargo moving across the border by truck to use Canadian ports is not subject to the tax, the result is enormous pressure to divert cargo away from the public ports of the United States.

<u>Summary</u>

In summary, taxes on trade are regressive -- taxes cannot be collected on commodities that are not being shipped internationally because they have been priced out of foreign markets or are escaping U.S. taxes by fleeing across the border to Canadian ports. Not only do our northern tier ports lose cargo to Canada, but, from a national perspective, the projected tax revenue is lost to the U.S. Treasury; cargo which could move efficiently by water is instead imposing a further load on our already overburdened highways and bridges. Worst of all, the tax is a disincentive to export. The Harbor Maintenance Tax undercuts our competitiveness in the international marketplace at a time when we should instead be expanding our trade horizons.

As Congress grapples with the difficult problem of reducing the deficit while encouraging economic recovery, we urge you to fulfill the pledge made in 1986 and return the Harbor Maintenance Tax to .04 percent. We believe that the fair remedy and the best for U.S. trade is to roll back the Harbor Maintenance Tax to .04 percent. At the very least we urge that the rate be set at no more than 100% of costs and that charges be limited to activities now authorized.

No new or increased taxes, fees, or other levies on international trade should be adopted without first assessing the cumulative impact on trade and our international competitiveness. The recently released CAO study should be an important tool in assessing impacts.

We appreciate this opportunity to comment on the President's proposals and look forward to working with you to enhance the competitive position of the United States in international markets by continuing to build and operate the best port system in the world.

Mr. GIBBONS. Thank you. Yes, sir. Mr. Cook.

STATEMENT OF HARRY N. COOK, PRESIDENT, NATIONAL WATERWAYS CONFERENCE, INC.

Mr. COOK. Mr. Chairman, my name is Harry N. Cook. I am president of the National Waterways Conference. Some 400 waterway-related businesses, industries and agencies participate in our organization, and they are principally companies which utilize the inland waterways to ship or receive their products as well as ports and terminals, water carriers, barge building and repair firms, State government agencies and river valley associations.

I wish to discuss the proposed $1 per gallon inland waterway fuel tax and the economic impact it will have on the mid-continent area, on America's basic industries and agriculture, and on the ports and waterways infrastructure. Moreover, this pending fuel tax is another trade tax, making it more difficult for U.S. producers to compete in foreign markets as the previous witnesses have just explained.

For generations the major export from America's river valleys was neither crops nor coal, but people. Often spurred on by inland waterway access to raw materials and growing markets, the economic development of our river valley economy since World War II is changing that equation.

As President Kennedy said in dedicating an Arkansas waterway project in 1963, "These projects protect and create wealth—new industries, new income, new incentives and interests, and the wealth they assure to one region becomes a market." Now, a new administration in Washington is seeking to inspire a Nation to think in terms of investing—investing in people, investing in infrastructure, investing in the future, investing in America. We would do well to see inland waterways as both the model and the methodology for what works.

All Federal navigation investments are subject to strict benefit-cost analysis in which the public benefits must exceed the public cost. It is all there in black, not red, ink for anyone to see. Inland waterway investment strategies involve communities and governments and the private sector as partners in their own destinies. The navigation system is a product of a joint venture in which the Federal Government is just one of the parties which makes it possible.

Other partners in this joint venture build and maintain the ports and terminals, elevators, storage facilities, access roads, and the manufacturing, refining and other plants that provide the jobs. None of the partners, including the Federal Government, can do it alone. If the proposed $1 per-gallon waterway fuel tax is imposed on top of present fuel taxes and a new Btu tax, Federal fuel taxes totaling $1.30 a gallon will raise fuel taxes by 1997 a staggering 665 percent, increase carrier costs by approximately 250 percent and hike barge freight rates by 40 to 50 percent or more. Because waterways move such large volumes of the fuels, raw materials, and farm crops which sustain American industry and agriculture, high-level increases in barge costs will reverberate throughout the U.S. economy.

Economic dislocations brought on by high-level fuel taxes will considerably worsen regional inequities. In effect, inland navigation allows the economies of inland regions to compete with coastal areas on a more level playing field. For instance, the coal in the West Virginia mountains has always been there, but without transportation this coal is almost valueless. The availability of transportation gives value to coal and ores and other raw materials. The less that transport to market costs, the more value it adds.

On the other hand, the more transportation costs, the less valuable it is. Nearly 30 years ago a distinguished chairman of this committee, the late Wilbur D. Mills, observed "that each new project which extends our inland waterways system becomes the beneficiary of every previous and existing project and vice versa. The effect on our Nation's efficiency and prosperity is cumulative."

Well, the impact of the pending reverse investment $1 fuel tax will be cumulative to consumers certainly, but interior river valleys will take the full brunt. Traffic on these newer segments to which Mr. Mills referred would decline precipitously to a point where users of the more heavily trafficked segments would demand an end to the cross-subsidization effect of high-level fuel taxes financing operation and maintenance costs for tributaries they seldom use. Some tributaries will close, then others, and then in a relatively short time, it is 50 years ago. An additional $1 fuel tax indexed to full cost recovery of Federal operation and maintenance outlays will lead to the dismantling of the inland waterways system as we know it and turn back the clock of progress in the name of change.

Thank you, Mr. Chairman, for allowing us to present this testimony.

Mr. GIBBONS. Thank you, Mr. Cook.

[The prepared statement follows:]

STATEMENT OF HARRY N. COOK
PRESIDENT OF THE NATIONAL WATERWAYS CONFERENCE, INC.
BEFORE THE COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES, WASHINGTON, D.C.

March 17, 1993

My name is Harry N. Cook, and I am president of the National Waterways Conference. Founded in 1960, the Conference is a nationwide organization of some 400 waterway-related businesses, industries and agencies. Our membership includes companies which utilize the inland waterways to ship or receive products as well as ports and terminals, water carriers, barge building and repair firms, marine insurance, state governments and river valley associations.

For generations the major export from America's river valleys was neither crops nor coal, but people. Often spurred on by inland waterway access to raw materials and growing markets, the economic development of our river valley economies since World War II is changing that equation. As President John F. Kennedy said when he dedicated an Arkansas waterway project the month before he died: "These projects protect and create wealth -- new industries, new income, new incentives and interests. And the wealth they assure to one region becomes a market for another -- so that the benefits of this project also help those who manufacture automobiles in Detroit, and those who make steel in Pittsburgh and those who make shoes in Massachusetts."

Even the Congressional Budget Office, which has criticized Federal water resources investments in the past, concedes that inland navigation promotes regional economic development and that Federal dis-investment in the form of a cost-recovery fuel tax will result in lower incomes. Moreover, the CBO is off base in asserting that inland water transport is the most heavily subsidized form of commercial freight transportation. By measuring Federal inland waterways expenditures as a percentage of the freight bill, rather than in terms of the total Federal investment for each of the transport modes or in subsidy per ton-mile, the CBO computation is skewed against low-cost transport. If barge rates were higher, the CBO computation would show that the subsidy was lower. Nonetheless, the low rates for inland water freight are proof that the savings in transportation costs afforded by Federal investments are being passed on to shippers, receivers and consumers.

A new Administration in Washington seeking to inspire a Nation to think in terms of investing -- investing in people, investing in infrastructure, investing in the future, investing in America -- would do well to see inland waterways as both the model and the methodology for what works. All Federal navigation investments are subject to a rigorous cost-benefit analysis in which public benefits must exceed the public costs. It's all there in black, not red ink, for anyone to see.

Inland waterway investment strategies involve communities and governments and the private sector as partners in their own destinies. The navigation system is the product of a joint venture in which the Federal government is just one of the parties which makes it possible. Other partners in this joint venture build and maintain the ports and terminals, elevators, storage facilities, access roads, and the manufacturing, refining or other plants that provide jobs. None of these partners -- including the Federal government -- could have done it alone.

In all, if the $1 tax is imposed on top of present fuel taxes and a new BTU tax, Federal fuel taxes totalling $1.30 a gallon by 1997 will raise fuel taxes by a staggering 665 percent, increase carrier costs by approximately 250 percent, and hike freight rates by 40 to 50 percent. Because waterways move such large volumes of the fuels, raw materials and farm crops which sustain American industry and agriculture, high-level increases in barge costs will reverberate throughout the U.S. economy. In an already weakened economy, not only will some water-dependent industries face cutbacks, but with grain and coal exports, employment and interior regions directly affected, the U.S. economy -- and long-held public policy objectives -- will surely suffer.

I refer to the defeat of important public policy goals such as the stimulation of growth in under-developed regions like Appalachia, the Ozarks and the Mississippi Delta; regional economic development through the Arkansas River, Tennessee-Tombigbee and Red River programs; rural-urban balance; export expansion and competitiveness; a finely crafted highway, rail and water transportation network, etc.

Economic dislocations brought on by high-level fuel taxes will considerably worsen regional economic inequities. In effect, inland navigation allows the economies of interior regions to compete with other regions on a more level playing field. For instance, the coal in the West Virginia mountains has always been there. But without transportation this coal is valueless. Transportation to market gives value to coal, ores and other raw materials. The less that transport to market costs, the more value it adds -- and vice versa.

A fuel tax of the proposed magnitude will be a heavy jolt to basic industry and agriculture that depend on barges to move massive quantities of raw materials, farm crops and fuels. Barges transport one-half the Nation's export grain, 30 percent of the petroleum and petroleum products, and a quarter of the coal for domestic electric utilities and export. But the real value of waterway transport cannot be related in tonnages alone. Commerce, like water, flows along the lines of least resistance. Production and industry have gravitated to the areas, and along the routes, of lowest costs. The industrial and agricultural development that has occurred along the inland waterway system of interior America has benefitted this Nation beyond measure.

Nearly 30 years ago a distinguished chairman of this Committee, the late Wilbur D. Mills, observed, "Each new project which extends our inland waterway system becomes the beneficiary of every previous and existing project and vice versa. The effect on our Nation's efficiency and prosperity is cumulative." The effect of this reverse-investment $1 fuel tax will be cumulative to consumers, certainly, but river valley economies will take the full brunt. Traffic on these newer segments, to which Mr. Mills referred, will decline precipitously to a point were carriers on more heavily trafficked segments will demand an end to the cross-subsidization effect of high-level fuel taxes financing operation and maintenance costs for segments they don't use.

Some segments will close, then others, and then in relatively short time, it is 50 years ago. An additional $1 fuel tax indexed to full cost-recovery of Federal operation and maintenance outlays will lead to the dismantling of the inland waterway system as we know it and turn back the clock of progress in the name of change.

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APPENDIX A

An Additional $1 Fuel Tax: Why Not?

NINE KEY REASONS WHY THE RECOVERY OF INLAND O&M COSTS IS DEFINITELY NOT IN THE PUBLIC INTEREST

The issue. The President's economic plan includes a proposal to fully recover operation and maintenance (O&M) costs of the shallow-draft inland navigation system. Cost recovery would be in the form of an additional tax on waterways fuel. After a four-year phase in, the tax would be $1 per gallon. This would be in addition to the current fuel tax (which pays for one-half of inland navigation construction and rehabilitation and will reach 20 cents a gallon in 1995) and the proposed BTU tax, which will add 10 to 15 cents per gallon to the cost of fuel.

Here is the text of the proposed $1-per-gallon fuel tax as described in the pending economic plan, "A Vision of Change for America:"

> *Phase-in increased Inland Waterway user fees.* The Nation's inland waterways are the most heavily subsidized form of commercial freight transportation. Since the system was constructed for commercial navigation beneficiaries, they should pay for all operation and maintenance costs. Existing inland waterway fuel taxes collected on applicable segments of the system only offset half of the Corps of Engineers' cost of construction and major rehabilitation (estimated at $430 million in 1993). This proposal would increase the 1994 Federal inland waterway fuel tax from 19 cents to $1.19 per gallon in a series of increasing steps to a total of $1.00. Estimated savings are $460 million in 1997, $820 million over four years.

The fuel tax will substantially raise barge rates. At present, waterway fuel costs about 60 cents a gallon and water transportation firms pay 17 cents a gallon in fuel tax, or 77 cents a gallon. Without including the proposed BTU tax, waterway fuel costs would jump to at least $1.80 a gallon by 1997 -- an increase of 234 percent! On a grain haul from St. Paul to Baton Rouge-New Orleans, fuel costs would rise from $3.13 per ton to $7.33 per ton. And the fuel cost in moving coal from the Kanawha River to the Gulf would go up by $4.41 per ton. When fuel costs go up so much, barge rates will take a leap, too. The $1 fuel tax will add at least 40 to 50 percent to freight rates.

Barge rate increases are difficult to pass on. In the case of export coal, advances in barge rates would be of a magnitude which are likely to kill off most overseas markets. Some coal now moving to the Gulf Coast by barge might shift to rail but find its way to East Coast ports, leaving Lower Mississippi River transfer points unused. In the case of export grain, any increases in transportation costs usually come out of farmers' pockets. This could trigger higher Government loans and other assistance. Barge rate increases could shift grain to railroads, which already face hopper-car capacity problems.

Consumers would bear the direct impact of the fuel tax. Large-scale increases in the cost of waterway transportation would be felt immediately in the marketplace. This is because river barges move such huge volumes of raw materials, fuels, and farm crops: coal for generating electricity, gasoline and home heating oil, tractor fuel and farm fertilizer, grain and soybeans, cement and other building materials, industrial chemicals, metallic ores, etc. Increases in water transportation rates will be reflected in the cost of electricity, gasoline, new construction, foodstuffs, and other consumer goods.

The $1 fuel tax will have other adverse effects. Barge transportation is so valuable because it is so economical. Without barges, many coal fields would not be competitive. Waterways are vital to many interior regions and industries, helping to make their products competitive in distant markets which they could not otherwise reach. In turn, these same areas become significant markets for the products of other areas. Besides, barge rates generally serve as the "floor" for overland rates. As river rates rise, so usually do rail and truck rates.

Exports could plummet as "trade taxes" escalate. Added to a host of other user taxes on U.S. exports, the proposed $1 fuel tax will make it more difficult for us to sell our products overseas. It's the accumulative impact of these fees and taxes which is such a burden to our exports. Waterborne commerce already pays a steep harbor maintenance tax, vessel tonnage tax, and a wide range of Customs and USDA inspection fees. In addition, half-a-dozen U.S.

Coast Guard user fees are pending. The $1 tax could send our trade deficit through the roof.

Modal shifts will have dire environmental apects. If the proposed $1 fuel tax diverts commerce from river barges to rail and truck, the environmental consequences will be severe. Overland modes are responsible for more air and noise pollution, more emisions, and more accidents. In Minnesota, for example, a recent study found that, if the state's barge traffic were shifted to rail, fuel use would increase by 331 percent, emissions by 470 percent and probable accidents by 290 percent! Waterway transportation is, in fact, the environmentally superior mode. Why penalize it with an unwarranted $1 fuel tax?

O&M cost recovery could dismantle the waterways system. In 1989, the 27 principal shallow-draft waterway segments carried 497.8 million tons of commerce. Or, considering the distance which the freight was towed, this amounted to 250.6 billion ton-miles. Almost 88 percent of this traffic moved on just three waterways: the Mississippi, Ohio and Gulf Intracoastal Waterway. If barge tows operating on these waterways were required to pay the proposed $1 fuel tax, it would "subsidize" numerous lower-volume channels. This sets up a situation which would be ripe for closing down tributaries and developing waterways. But if they were shut down, the entire system would suffer.

The Federal-private sector partnership would be ended. Since 1824, the Federal government has improved rivers and harbors for the public good. Such investments are credited with reducing freight rates, since waterways are "public ways" and tough competition among bargelines has lowered transportation costs. While the Federal government has provided in-channel improvements, non-Federal interests have invested many billions in landside terminals, elevators, docks and other facilities. This public-private investment pays significant dividends, which is now in jeopardy because of the pending $1 fuel tax.

Multi-purpose water resource development would suffer. Barge navigation is frequently a beneficiary of river programs undertaken for a variety of public purposes: flood protection, hydropower, water supply, bank stabilization, etc. If navigation were halted, much of the maintenance outlays would continue. For instance, the entire Lower Mississippi is funded as flood protection, with 25 percent of the cost arbitrarily allocated to navigation. Dams are often installed for purposes other than navigation, such as for generating hydropower, providing flood control or preventing saltwater intrusion. In short, navigation is part of comprehensive water resources management.

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APPENDIX B

IMPACT OF A NEW $1 WATERWAY FUEL TAX ON AGRICULTURE

Of all the commodities shipped on America's inland waterways, food, fiber and fertilizer account for 40 percent of all ton miles. More than half of all U.S. export grain goes to deepwater port by barge. In 1989, corn movements alone (1.28 billion bushels) nearly equaled the entire corn production of the states of Kansas, Ohio, Indiana and Michigan. Wheat movements (514.5 million bushels) exceeded the entire production of wheat in Kansas, Missouri, Nebraska, Iowa and Indiana. Cost-efficient river transportation providing access to distant markets is a vital component of interior agricultural economies. A new $1-per-gallon fuel tax must be rejected.

The proposed additional $1 tax on barge fuel — on top of the 20-cent-per-gallon tax scheduled to be fully phased in by 1995 and the proposed BTU tax which will add another 10 cents a gallon or more to the cost of fuel — therefore is a disastrous imposition on the Nation's agricultural economy. These increases will add at least 40 to 50 percent to freight rates and could eliminate an important advantage in world competitiveness. For export grain, higher fuel taxes amount to a "trade tax" bound to hurt the U.S. position in international trade, and prove a disaster for many farmers who can't pass on the increase to foreign buyers. More specifically:

Water transport costs will skyrocket. Although the fuel tax impact on farm economies will vary widely depending on the shipping distance, a USDA study estimates that a user tax of $1 a gallon will add an average of 12.5 cents per bushel to the cost of moving grain by barge to deep-water ports. For many producers, the impact is even more dramatic. Under an additional $1 tax, the per-ton fuel cost of grain shipped to Gulf ports from Pekin, IL, would rise from the current $1.71 to $3.99 in 1997; from Dubuque, IA, from $2.35 to $5.47; and from St. Paul, MN, from $3.13 to $7.33.

Farmers will absorb higher rates. The price of grain is set in the world marketplace based on supply and demand. Thus the increased costs of the inland waterways fuel tax — estimated at 10 to 18 cents per bushel or at least $5 per ton for Farm Belt grains headed for the Gulf of Mexico — cannot be passed on to foreign buyers. Grain companies can't be expected to absorb such an increase at a time when a fraction of a cent per bushel can determine their competitive position against grain from Europe, South America, Australia, Canada and elsewhere. Neither can barge companies, who now receive only about $4.80 per ton for the haul. Therefore, increased costs of transporting grain will be borne largely by U.S farmers.

Farm production costs will rise. Although farm production essentials may reach local suppliers by truck or rail, raw materials required to produce insecticides, herbicides and other chemicals; tractor fuels, heating fuel, lubricants and other petroleum products; and of course, fertilizer, likely travel by waterway during the continuum of transportation linkages. Higher barge fuel taxes thus would have a multiplier effect, resulting in ever-escalating costs of producing the final product. Also, smaller refiners and cooperatives who cannot afford to build pipelines, and who keep prices down in rural areas, especially rely on the availability and cost efficiency of river transport.

Federal farm aid outlays will increase. Decreased farm prices mean more demands on USDA transfer payment and loan programs. Based on current production patterns, each 1-cent decrease in the price farmers receive for a bushel of export corn would increase USDA deficiency payments by more than $30 million, for example, and the USDA must brace for significantly increased use of Federal loans to help strapped farmers. In fact, USDA outpayments and loans alone as a result of the fuel tax could be significantly higher than revenue derived from the new high-level waterway fuel tax.

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APPENDIX C

IMPACT OF A NEW $1 FUEL TAX ON COAL AND RELATED INDUSTRY

Without the economical availability of inland water transportation, coal would lose much of its appeal to domestic industry and electric utilities as well as its competitive price on the world market. Coal accounted for more than one-third of all inland waterway tonnage in 1990 and showed a one-quarter increase over 1985.

The proposed $1 additional tax on barge fuel — on top of the 20-cent-per-gallon tax scheduled to be fully phased in by 1995 and the proposed BTU tax which will add another 10 cents a gallon or more to the cost of fuel — must be rejected. Not only will it be a disastrous imposition on the Nation's coal region and coal economies, it will also set off unintended reverberations throughout the national economy, adversely affecting river valley industries, electricity consumers and the Nation's trade balance.

Shipping costs will skyrocket. Fuel is a larger component of barge transport costs than for other transportation modes. Barge fuel now costs approximately $0.77 a gallon, including the current fuel tax. When the additional $1 tax is fully imposed in 1997, the fuel cost would rise to $1.80 a gallon. The fuel cost alone would exceed the current rate for moving West Virginia export coal to the Gulf. The fuel cost for coal exported from the Ohio Valley, now $3.29 per ton from the Kanawha River to the Gulf of Mexico, would rise to $7.70 per ton. Even fuel cost for relatively short hauls for domestic users, such as iron and steel industries, would rise dramatically — from $1.18 per ton to $2.77 per ton for hauls from Big Sandy to Pittsburgh, for example, and from $0.74 per ton to $1.74 to Cincinnati.

Overseas markets will be killed off. At a time when competition from other countries is especially aggressive, and newer coal producers such as Indonesia are entering world markets with inherent cost advantages, proposed advances in barge rates would be of a magnitude likely to kill off most overseas markets. Some export coal now moving to the Gulf Coast by barge might shift to rail destined to East Coast ports, leaving Lower Mississippi River and Gulf Coast transfer points unused. Multimillion-dollar coal handling facilities primarily developed by private sector investments, would produce no returns.

Electricity generation costs will rise. Eighty percent of barged coal goes to electric utilities, and half the Nation's electricity comes from coal. Just one electric utility, the Southern Company, estimates that the $1 tax will raise its annual coal bill by almost $21 million. For electric utilities, adjusting to higher coal prices will be more complex than merely passing on the increase to consumers. Utilities must, for the long term, consider the feasibility of switching to alternative generating fuels. Then, as well, construction and other costs would be passed on to consumers.

Industry production costs will rise. Inland waterway development, especially the navigational component, since World War II has stimulated economic growth in depressed regions such as Appalachia and the Ozarks. High-level fuel taxes will slow the expansion of coal-consuming industries which are situated in market-distant river valleys because of the availability of economical water transportation. Even now, transportation charges account for nearly half of coal's delivered value. Moreover, archetypal coal-consuming iron and steel makers especially will suffer a multiplier effect of higher costs during a continuum of river transportation linkages (e.g., coal barged to coke making facilities, coke and scrap barged to mill, and finished product barged to markets).

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APPENDIX D

THE INLAND WATERWAYS ANSWER THE CHARGE OF SUBSIDY

The charge of subsidy to the barge industry is used to justify the full recovery of Federal navigation investments through taxes on the barge and towing industry, such as the pending $1-per-gallon fuel tax. The 25,000-mile inland waterway system was not developed, however, to benefit the barge industry. The primary motivation was regional and national economic development. Rarely if ever have barge firms testified or lobbied in support of new navigation systems. Almost without exception, they have been pushed by Governors and economic development interests as a means of enticing industry to locate in their states and of providing the products of their mines, mills and farms with economical access to markets. Thus, navigation programs have been viewed as cataylsts in generating jobs and incomes, expanding the local tax base, and contributing to a higher standard of living.

In its wisdom, Congress made sure that entire regions would share in the benefits of economical water transportation. It guaranteed that the cost savings afforded by its navigation investments would be passed on to shippers and receivers and ultimately to consumers. This objective was achieved by providing almost unlimited access to the water transportation channels, setting off fierce competition among bargelines. This competition ensured that towing companies did not reap windfall profits. Moreover, the competition serves to restrain barge rates, and the savings in transportation costs are widely diffused throughout the regional economy.

Since World War II, the Federal government has invested approximately $10 billion in navigation programs. These investments were not made to benefit barge companies. Most water development has been for multiple public purposes, including such objectives as flood protection, water supply, hydropower, irrigation, water recreation, etc. Even if navigation were terminated, a large percentage of the Army Corps of Engineers' maintenance costs on many waterways would continue. Without these programs, entire regions would suffer from devastating floods, lack of adequate water supplies for municipal and industrial use, electric power shortages, loss of water recreation opportunities, fish and wildlife depletion, etc.

Federal navigation expenditures benefit broad reaches of the Nation. Not one penny of Army Corps of Engineers' outlays goes to barge and towing companies; it all goes for infrastructure providing a "public way" serving interior river valleys and coastal areas. Even then, these investments fall far short of creating a water transportation system. Billions of dollars of state and local funds as well as private capital are required to make the navigation system operational: docks, wharves, elevators, warehouses, access roads, police and fire protection, etc. In the Arkansas Valley, for example, the Federal government spent about $1.3 billion to construct the McClellan-Kerr Arkansas River Navigation System but private firms attracted by the availability of low-cost water transportation have invested more than $3 billion in riverside facilities, providing at

least 52,000 jobs. Non-Federal entities have provided millions more for port facilities, connecting roads and interchanges, and support services.

Unlike any other Federal program, water resources projects are subject to strict benefit/cost analysis and only those programs whose public benefits substantially exceed their public costs are then considered for funding. Public costs include estimated operation and maintenance costs over the economic life of the project, and benefits are discounted to present-day values. These are "public benefits" accruing to the national economic development account -- and they certainly are not a measure of financial gain to be realized by the barge industry. Barges, in fact, perform an intermediary service in moving the products of mines, mills and farms, but the full recovery of Federal infrastructure investments would jeopardize much if not most of this traffic.

The Federal government subsidizes each of the various transportation modes in many different ways. Trucks use many highways and city streets on which public entities annually spend billions of dollars which are not recovered through user fees. Railroads are the beneficiaries of such Federal programs as grade crossings and pension fund bailouts, and when Conrail was sold in the mid-1980s some $7 billion in Federal loans were written off. Waterway subsidies come entirely in the form of infrastructure improvements which provide access to interior river valleys, which otherwise would be without the freight rate restraint provided by barge service.

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Mr. GIBBONS. Now Mr. Lucas.

STATEMENT OF J. STEPHEN LUCAS, DIRECTOR, LOGISTICS AND OPERATIONS, LOUIS DREYFUS CORP., WILTON, CT, ON BEHALF OF THE NATIONAL GRAIN & FEED ASSOCIATION

Mr. LUCAS. Thank you, Mr. Chairman. I am Steve Lucas, director of operations and logistics for Louis Dreyfus Corp. of Wilton, Conn. I am a member of the inland waterway user board which is a Federal advisory committee charged with recommending the priorities of navigation projects to both the President and the Congress. I am also the chairman of the waterborne commerce committee for the National Grain & Feed Association.

The National Grain & Feed Association is a trade association representing 1,200 firms, 5,000 facilities, and State affiliated organizations with more than 10,000 members nationwide. I want to thank you for this opportunity to appear here today and share with you the concerns that the agricultural sector of this economy have about the proposed dollar a gallon fuel tax.

Now, in my written remarks we have many reasons why one should be in opposition to this. Given that I am in the unenviable position of bringing up the rear today, I would like to share just a couple of those with you. First, we believe that the dollar a gallon tax increase would significantly decrease farm income. Unfortunately, as my colleague from the port of Duluth pointed out this is a terribly competitive business. We cannot pass those kinds of costs on to the foreign customer because we have to compete in a worldwide market with the South Americans, the Europeans, the Far East.

The grain companies and the barge companies of this country cannot absorb this kind of an increase because the $820 million projected to be raised over 4 years is probably more than the gross margins of all of the grain export companies and barge companies put together. That only leaves one person in the chain to absorb this cost, and that is the producer, the farmers in America. I believe that is also true for the coal mine operators in America, too, that those costs cannot be passed along to consumers. Therefore, we are going to see barge lines and export companies passing the tax producers, and gross farm income will decline. The National Grain & Feed Association estimates that farm income could decline, in just those States that touch on the major rivers, by as much as $431 million annually.

Second, Mr. Chairman, this proposal, as Mr. Farrell has related already a little bit, appears to be put together in haste, and on the basis of faulty economic theory. This proposal for a dollar a gallon increase in the fuel tax is estimated to raise some $460 million in the fourth year of implementation. That estimate assumes that as we increase fuel taxes from the present 17 cents per gallon to $1.19 in the last year, the traffic will remain the same on the inland rivers, that it won't be diverted to the rails, to the trucks. I believe it is faulty elementary economic theory to say that as the price of things go up, demand stays the same. I don't believe that is true and I don't believe Congress has repealed that law of economics yet.

Third, we are also concerned about this dollar a gallon tax.

Mr. GIBBONS. We would if we could, but we can't.

Mr. LUCAS. I understand that, Mr. Chairman. We are also concerned about this $1 a gallon tax increase, Mr. Chairman, as eroding our competitive advantage, especially in corn and other feed grains. We are very concerned about that leading us down the path to giving up our advantage, to losing market share in the agricultural sector which gives a big impetus to the balance of payments in this country.

Our idea, Mr. Chairman, is that we are doing our share to balance those payments with foreign countries. We are trying to make our system as efficient as we can, both production and transportation. The $1 a gallon tax increase will take money out of the farmers pocket from his sales proceeds and by increasing the cost of his inputs, such as fertilizer, which move by barge. This tax will eventually erode the farm economy to the great detriment of this country.

Mr. Chairman, I appreciate your attention. I would be happy to answer any questions.

[The prepare statement follows:]

TESTIMONY BY

J. STEPHEN LUCAS

BEFORE THE COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 17, 1993

Mr. Chairman and members of the committee:

First, I want to express my thanks to the committee for inviting the National Grain and Feed Association to testify on an issue of vital importance to the agricultural sector of the economy.

I am Steve Lucas, Director of Logistics and Operations for Louis Dreyfus Corporation of Wilton, Connecticut. I am a member of the Inland Waterway Users Board, a federal advisory committee which is charged with recommending priorities of navigation projects to the President and the Congress. Also, I am the chairman of the Waterborne Commerce Committee of the National Grain and Feed Association.

The National Grain and Feed Association (NGFA) is the national nonprofit trade association of 1,200 grain, feed and processing firms comprising 5,000 facilities that store, handle, merchandise, mill, process and export more than two-thirds of all U.S. grains and oilseeds utilized in domestic and export markets. The NGFA also consists of forty affiliated state and regional grain and feed associations whose members include more than 10,000 grain and feed companies nationwide. NGFA is the nations largest agribusiness organization.

I am appearing before you today to urge you to oppose the proposed $1 per gallon tax increase on diesel fuel used by commercial towing companies on the inland waterways.

NGFA's and my company's opposition to this five-fold tax increase is based on the following five reasons:

First, the $1 per gallon tax increase would lead to significantly decreased farm income. In 1991, sixty-five percent of all U.S. grain exports, a total of sixty-three million tons with a total value of $10 - 15 billion, moved on the inland waterways. The price of these grains and oilseeds is determined by worldwide supply and demand in a global marketplace where U.S. farmers must compete with the production of farmers in Europe, South America, and the far East. It is very unlikely that this proposed increase in transportation costs[1] could be passed on to

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[1] "Transportation is a key element in the marketing system of bulk agricultural commodities. ... Since most grain shipped by barge is destined for an export point, **the cost of barge transportation is a key issue in the total cost of marketing export grain. This cost is**

foreign buyers who have a large choice of alternative suppliers.

Additionally, merchandising margins in the grain and feed industry are extremely thin as are the operating margins of most barge carriers. A tax increase of this magnitude is larger than the combined margins of both the export grain and barge industries. Thus, it is inconceivable that this increase could be absorbed by these industries.

The only segment of the industry remaining to absorb this tax increase is the producer himself. A 1985 study by the Department of Agriculture[2] showed that fully seventy percent of a five cent per bushel fuel tax would be borne by the U.S. farmer. With another $1 per gallon in taxes, I believe that this percentage will increase to the 85 to 95 percent level. The National Grain and Feed Association estimates that this tax will cause declines in annual farm income of up to $431 million per year, just in those states which are directly adjacent to the waterways.

Second, the $1 per gallon tax increase is applied unfairly to only one segment of inland waterway users. Barge navigation is only one of many beneficiaries of inland river operations. Many programs are undertaken for a variety of public purposes, i.e. flood reduction, hydropower, water supply, and bank stabilization. In the absence of all commercial navigation, costs for these other purposes would continue, but the commercial navigation interests are now being asked to pay for all of these costs. By way of analogy, this would be akin to asking the commercial trucking industry to pay for all of the operations and maintenance of the interstate highway system.

Third, the projected revenues derived from the $1 per gallon tax are based on faulty economic theory. The present proposal estimates revenues in 1997 from this tax to be $460 million. However, this estimate is based on traffic volume remaining constant or even increasing slightly in the face of a five-fold increase in operating costs.

As farm income decreases due to this tax and the cost of production increases due to higher transportation costs of inputs such as fertilizer, overall farm production and U.S. exports will decline. In fact, the USDA study quoted earlier estimated that a five cent per bushel tax would cause a decrease in U.S. grain exports of 365,000 tons. With the $1 per gallon increase, exports could fall more than twice that amount. Thus, as the volume of export grain declines, the revenues from this tax would also decline to levels far below the projected $460 million.

In addition, there is good reason to believe the true net revenue increase that

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especially important with the increased competition from several grain exporting countries. Increased operating costs for barge operators may be reflected in higher transportation rates and reduced bids to producers by river elevators [emphasis added]." Patricia Miller & Lowell D. Hill, ORGANIZATION AND STRUCTURE OF THE BARGE INDUSTRY TRANSPORTING GRAIN AND OILSEEDS, Department of Agricultural Economics, Agricultural Experiment Station, College of Agriculture, University of Illinois at Urbana-Champaign (May 1986).

[2] Theresa Sun & Lester Myers, A WATERWAY TAX ON GRAINS: A FUNCTIONAL MARKET ANALYSIS, United States Department of Agriculture, Economic Research Service, Technical Bulletin Number 1705 (July 1985).

would be realized by government has been vastly overstated. Given the proximity of the corn belt region to the river system, we would expect midwestern corn prices to be depressed in a range of four to eight cents per bushel, depending on location. If we assume an average decline of five cents per bushel, revenue gains from this tax would be offset by increased federal deficiency payments under current government farm programs.

Based upon USDA's own Final Regulatory Impact Analysis, November 16, 1992, a five cent per bushel decline in corn price would cause additional government costs in a range of $300 to $500 million. This impact is for corn and feed grains alone. The added program cost to the federal government due to lower wheat and soybean prices would be in addition to this cost. Thus, even with conservative assumptions about the farm price impact of the tax, we believe a more careful assessment of the full impacts of this tax would demonstrate that the federal government would actually lose revenue rather than gain it with this proposal.

Fourth, the $1 per gallon tax increase will divert traffic from the inland waterways to other modes of transportation with significant environmental impacts. Barge transportation on the inland waterways is the most environmentally friendly mode, using less fuel per ton-mile, creating less air and noise pollution and having a superior safety record for the movement of petroleum and hazardous chemicals.

In a study conducted by the Minnesota Department of Transportation, it was found that if waterway traffic in Minnesota, one of the states most affected by this tax, was shifted to rail, fuel use would increase by 331 percent, emissions would increase by 470 percent and probable accidents would increase by 290 percent. For a shift from barge to truck, the increases would be 826 percent, 709 percent, and 5,967 percent, respectively. Thus, by driving cargo to other less environmentally friendly modes of transportation, this tax poses significant environmental risks for all Americans, not just those concerned with commercial navigation on the inland waterways.

Fifth, as a final point, we are extremely concerned about how such a heavy tax will affect U.S. cost competitiveness with our major competitors. The attached table reports data from a recent Purdue University study that indicates the U.S. has four major competitors in corn production whose average cost of production is $3 per ton less than U.S. However, the high level of efficiency in the U.S. marketing system gives the U.S. farmer a $9 per ton advantage in delivering corn to world customers. Looking at total delivered cost, the U.S. farmer has a slight advantage of $6 per ton over major competitors. This heavy taxation of waterways, would effectively add about $3 per ton to the delivered price. Thus, with this one action, the U.S. government would be eroding 50 percent of our competitive advantage that we currently have in the production and delivery of corn to world markets. Most experts agree that the U.S. has its greatest comparative advantage in the production and marketing of corn, with even stiffer world competition in the production and delivery of soybeans and other grains, so the percentage loss in our competitive position for other sectors would be even greater. If agriculture is to be given a legitimate opportunity to grow and expand its share of world markets, we must protect our natural competitive advantages and efficiencies in the transportation infrastructure.

However, the grain and feed industry also recognizes the need for all Americans to share in the process of reducing the federal deficit. To that end we would like to make the following suggestions in order to reduce spending and/or increase revenues from the inland waterway sector:

First, the Congress should look to implement a meaningful reorganization of the Corps of Engineers structure. The Corps itself has already put forth a plan to reorganize which would lower its overhead by an estimated $115 million per year. Although this plan has been put on hold pending further review, we believe that even further savings could be found by efficient reorganization of the Corps of Engineers manpower and resources.

Second, along with any reduction in the overhead of the Corps of Engineers, the Congress must look to reduce Corps of Engineers spending on navigation operation and maintenance. Through careful review of projects and procedures, it would be possible to reduce the Corps operation and maintenance spending by $35 - 40 million per year.

Third, spreading the tax burden of operating and maintaining the inland waterways to other beneficiaries of the system would bring in additional revenue. It would seem more than equitable that users of the inland waterways other than the commercial towing industry should also contribute to the maintenance and operation of a system which provides many recreational, hydropower and water supply programs. Such revenue increases, while small individually, could easily total to $50 million per year.

Thus, by focusing on the three areas outlined above the Congress could easily meet the $200 million a year goal contained in "A Vision For Change" without completely crippling the agricultural sector of our economy which is so vital to our country's balance of payments and continued economic growth.

Thank you again, Mr. Chairman. I would be glad to respond to any questions.

Production and Marketing Costs for Corn: U.S. and Major Competitors*

	Average Cost of Four Major Competitors**	**Average Cost U.S.A.**
Variable Production Cost	**$56 per ton**	**$59 per ton**
Average Marketing Cost	**$34 per ton**	**$25 per ton**
Total Delivered Cost	**$90 per ton**	**$84 per ton**

*Data are from : Indiana Agriculture 2000: A Strategic Perspective, Purdue University,
June 1992. Data are based upon 1986 estimates, presumed to the most recent comparative data available on international competitiveness.

**Competitor countries include: Argentina, Brazil, S. Africa, and Thailand.

Mr. GIBBONS. Well, I want to thank each of you very much and just observe I realize that many of these so-called fees or taxes that masquerade as fees are the result of lip reading and strong positions the Presidents took for the last 12 years. I have had to endure the burden of trying to meet the Presidents' demand for more money and no new taxes, and that is where this tax disguised as a fee, harbor maintenance and everything else that you all described here. Most of them got all blown out of proportion, and they really make no sense.

I am always impressed at the vitality of the American producer and the economy when I realize what a burdensome tax collection system we have placed upon you. It is atrocious. There is a far simpler way of raising money and with less economic loss than we have now, so I will direct your attention respectfully, not respectful of my ideas. I have proposed a value-added tax system or business activities tax or something like that. I think makes far more sense. It would liberate Americans from 250 billion to 300 billion dollar's worth of pointless paperwork that we do just to collect the current revenue, and you all are the victims of some of that, too, and I think just a one point of additional value-added tax would be enough to offset all of the taxes that you are already paying through these very circuitous routes, so take a look at what I have done.

If you are interested, just call my office. We will be glad to mail you a copy of the proposal. I am acutely aware of what you all represent because, as you know, I have a very large port in the port of Tampa, and I know how all these things impact upon those people who have to operate that port, how it operates upon our international competitiveness. I appreciate what you have had to say about that. So I don't have any questions for you. I hope that there is some way we can finally make sense of the tax burden and not collect it in the very circuitous manner in which we do it, in the very clumsy manner in which we do it, in the very distorting manner in which we do it. So we will close these hearings on that thought and appreciate your coming, your devoting your time to it.

This concludes the hearings for today. We will begin on March 23 on the next series of hearings. Thank you very much.

[Questions for the record from Representative Reynolds and a response from Mr. Helberg follow:]

Question. Ms. Aylward, and Mr. Helberg, your written testimony argues vigorously on the issue of cargo diversion, and the impact it has on Great Lakes ports, among others. As the Congressman whose district includes the Port of Chicago, this issue concerns me a great deal.

Can you, Mr. Helberg, as a representative for American Great Lakes Ports, provide me with information as to the level of cargo diversion for the Port of Chicago? I would greatly appreciate whatever information you can provide.

Answer. It's extremely difficult, if not impossible, to identify precisely just which tax or tax increase has the effect of diverting cargo from one country to another. Our written statement refers to a recent U.S. Maritime Administration study which reports that more than $11 billion in U.S. trade moved through Canadian ports in 1989. The Marad study also shows that the Chicago Customs District received import cargo valued at $1.358 billion and transhipped export cargo valued at $44 million via Canadian ports. We cannot pinpoint the exact amount of this cargo lost by the Port of Chicago's maritime industry and labor as a direct result of U.S. maritime taxation. In Chicago's case, cargo also can be, and often is, diverted away from the Great Lakes-St. Lawrence Seaway system by either east-west transcontinental railroads or by barge lines serving the Illinois and Mississippi River systems. In other

words, maritime taxes work against the Seaway system in two ways: When they're not diverting cargo to Canada, they're also tending to divert cargo to other modes of transportation. While I cannot offer exact figures, this latter comment underscores the point that no new or increased maritime taxes should be levied without a thorough examination of the impact of those taxes on existing trade.

[Whereupon, at 12:45 p.m., the committee adjourned, to reconvene at 10 a.m., Tuesday, March 23, 1993.]

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